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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1957

No. 108

COMMISSIONER OF INTERNAL REVENUE, ET AL.,
PETITIONERS,

vs.

P. G. LAKE, INC., ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

PETITION FOR CERTIORARI FILED APRIL 17, 1957

CERTIORARI GRANTED JUNE 3, 1957

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1957

No. 108

COMMISSIONER OF INTERNAL REVENUE, ET AL., PETITIONERS,

VS.

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[fol. a] [Caption omitted]

[fol. 1] **IN THE TAX COURT OF THE UNITED STATES**

DOCKET NO. 48684

P. G. LAKE, INC., Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent.

APPEARANCES

For Petitioner: Harry C. Weeks, Esq.
For Respondent: Paul M. Newton, Esq.

DOCKET ENTRIES

1953

May 22—Petition received and filed. Taxpayer notified. Fee paid.

May 27—Copy of petition served on General Counsel.

Jul. 23—Answer filed by General Counsel.

Jul. 23—Request for hearing in Dallas, Texas filed by General Counsel.

Jul. 28—Notice issued placing proceeding on Dallas, Texas calendar. Service of answer and request made.

1954

Dec. 14—Hearing set February 14, 1955, Dallas, Texas.

[fol. 2] 1955

Feb. 14—Hearing had before Judge Murdock on the merits. Stipulation of facts and exhibits A thru H filed at hearing. Briefs due 4/15/55. Replies due 5/16/55.

Mar. 28—Motion for extension to May 15, 1955 to file brief filed by General Counsel. 4/5/55 Granted both parties.

Mar. 29—Transcript of hearing 2/14/55 filed.

May 5—Petitioner's opening brief filed. Copy served.

May 10—Motion for extension of 30 days or to 6/14/55 to file brief filed by General Counsel. 5/12/55 Granted to May 31, 1955.

1955

May 31—Brief filed by General Counsel. Copy served 6/1/55.

Jun. 3—Stipulation to correct transcript filed.

Jun. 13—Reply brief filed by taxpayer. Copy served.

Sept. 20—Opinion filed, Murdock, Judge. Decision will be entered under Rule 50. Copy served 9/20/55.

Dec. 29—Agreed computation filed.

1956

Jan. 18—Decision entered, Murdock, Judge, Div. 3.

Apr. 9—Petition for review by United States Court of Appeals, Fifth Circuit, with assignments of error filed by respondent.

April 23—Proofs of service filed. (2).

May 14—Certified copy of order of Court of Appeals, Fifth Circuit, directing that original exhibits received and made a part of the record before the Tax Court, including those attached to the stipulation of facts, be transmitted as [fol. 3] a part of the transcript of record on review, filed.

May 16—Agreed praecipe for record file.

* * * * * * *

IN THE TAX COURT OF THE UNITED STATES

[Title omitted]

PETITION—Filed and received—May 22, 1953

The above named petitioner hereby petitions for a redetermination of the deficiencies set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau Symbols DIR:DAL:A:90-D), dated April 24, 1953, and as the basis of its proceeding alleges as follows:

I

The petitioner is a Delaware corporation with its principal office at 858 Fair Foundation Building, Tyler, Texas. The returns for the period here involved were filed with the Collector of Internal Revenue for the Second Collection District of Texas at Dallas, Texas.

[fol. 4] II

The deficiency notice (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on April 24, 1953.

III

The deficieneies, as determined by the Commissioner, are in income and excess profits taxes for the calendar years 1949, 1950, and 1951, in the following amounts:

1949:		
Deficiency in income tax		$9,060.79
1950:		
Deficiency in excess profits tax	$76,607.70	
Deficiency in income tax	35,895.46	
Total deficiency in income and excess profits tax		112,503.16
1951:		
Deficiency in income tax		12,026.24

All of said excess profits tax and substantial portions of the asserted deficiencies in income tax for each of said years are in controversy.

[fol. 5] IV

The determination of tax set forth in said deficiency notice is based upon the following errors:

(a)—In each of the years 1949, 1950 and 1951, the respondent erroneously treated amounts paid for "transferred allowables" and "substitute royalties", as those terms are hereinafter more fully explained, as royalties paid by petitioner for the purpose of computing petitioner's allowance for depletion, with respect to certain oil and gas leases operated by it, under Section 114(b)(3) of the Internal Revenue Code.

(b)—The respondent erroneously determined that petitioner received in 1950 ordinary depletable income from certain oil and gas leases, rather than long-term capital gains, from the sale of a limited overriding royalty or oil payment interest in said oil and gas leases, and in not determining that said sale produced long-term capital gain to petitioner, taxable as such under Section 117 of the Internal Revenue Code.

V

The facts upon which the petitioner relies as the basis for this proceeding are as follows:

(a)—During all of the times pertinent to this proceeding, petitioner was primarily engaged in the business of

acquiring and developing oil and gas properties and producing oil and gas therefrom. During all of said times, petitioner's books and records and its tax returns were kept, maintained and made up the accrual basis and for [fols. 6-9] calendar year periods. The properties of petitioner directly involved in this proceeding, and hereinafter more fully referred to, were oil and gas leaseholds on lands in what is known as the East Texas Oil Field, each of which leaseholds petitioner had owned for several years prior to 1949. During the entire period of its ownership of said leaseholds, and each of them, petitioner held the same for productive use in its trade or business and not for sale.

(b)—The operation of oil and gas properties in the aforesaid East Texas Oil Field, together with the amount of oil which can be produced from oil wells and oil and gas leases in that field are, and were at all times pertinent hereto, under the control of the Railroad Commission of Texas, and during all pertinent times the Railroad Commission of Texas exercised its jurisdiction and authority over producing operations in that field. The Railroad Commission of Texas from time to time fixed the amount of oil per day and per month which could be produced from oil wells and oil and gas leases in that field; the amount of such permitted production being ordinarily referred to as the "allowable" oil production.

* * * * * * *

[fol. 10] (g)—In 1950, petitioner was indebted to P. G. Lake of Tyler, Texas, in the total sum of $600,000, which indebtedness was evidenced by petitioner's notes then held by the said P. G. Lake. In payment of this indebtedness petitioner, in 1950, assigned to the said P. G. Lake limited overriding royalty or oil payment interests, by which the said P. G. Lake became the owner of one-fourth (1/4) of 7/8ths of the oil and gas then under the aforesaid Owens and Reid Leases owned by petitioner, and entitled to that percentage of the oil to be produced therefrom until he, the said P. G. Lake, had received oil of the value of $600,000, plus an amount equal to that which interest would produce on the declining balance of $600,000 remaining from month to month unsatisfied, the amount equal to interest to be

calculated at the rate specified in said conveyance. In its tax return for the calendar year 1950, petitioner treated this transaction as a sale of capital assets for the sum of $600,000, and the resulting profit as long-term capital gain, taxable to it as such under Section 117 of the Internal Revenue Code. In determining the deficiency here involved, the respondent refused to treat said transaction as a sale of capital assets, but treated said $600,000 as a part of petitioner's gross income from the respective properties, sub-
[fol. 11] ject to allowances for depletion, and the gain, as so calculated, as ordinary income. Petitioner alleges upon information and belief that it correctly reported and treated its gain from said transaction in its 1950 tax return, and that the respondent's action, as above outlined, was erroneous.

Wherefore, the petitioner prays that this Court may hear this proceeding and determine that the respondent erred in each and all of the respects hereinabove set forth; that the deficiencies so determined by respondent against petitioner be redetermined in accordance herewith; and that petitioner may have all of the other and further relief to which it may be justly entitled under the facts alleged.

Harry C. Weeks, 525 Fort Worth National Bank Bldg., Fort Worth, Txas, Attorney for Petitioner.

Weeks, Bird, Cannon & Appleman, of Counsel.

[fol. 12] *Duly sworn to by P. G. Lake. Jurat omitted in printing.*

IN THE TAX COURT OF THE UNITED STATES

[Title omitted]

ANSWER—Filed July 23, 1953

Comes now the Commissioner of Internal Revenue, by his attorney; Kenneth W. Gemmill, Acting Chief Counsel, [fol. 13] Bureau of Internal Revenue, and for answer to

the petition filed in this proceeding, admits and denies as follows:

I, II and III

Admits the allegations in paragraphs I, II and III of the petition.

IV

(a) and (b). Denies that respondents determination is based upon errors as alleged in subparagraphs (a) and (b) of paragraph IV of the petition.

V

(a). Admits the allegations in the first three sentences and for lack of information denies the remaining allegations of fact in subparagraph (a) of paragraph V of the petition.

(b). Admits the allegations in the first two sentences and for lack of information denies the remaining allegations of fact in subparagraph (b) of paragraph V of the petition.

(c). For lack of information denies the allegations of fact in subparagraph (c) of paragraph V of the petition.

(d). Denies the allegations of fact in subparagraph (d) of paragraph V of the petition.

(e). Admits the allegations in the first sentence and denies the remaining allegations of fact in subparagraph (e) of paragraph V of the petition.

[fols. 14-29] (f). Admits the allegations in the first sentence and denies the remaining allegations of fact in subparagraph (f) of paragraph V of the petition.

(g). Admits the allegations in the first sentence and denies the remaining allegations of fact in subparagraph (g) of paragraph V of the petition.

Denies generally and specifically each and every allegation in the petition not hereinbefore expressly admitted, qualified or denied.

Wherefore, it is prayed that the determination of the Commissioner of Internal Revenue be approved.

(Signed) Kenneth W. Gemmill, ATA, Acting Chief Counsel, Bureau of Internal Revenue.

Of Counsel: James L. Backstrom, Regional Counsel; Allen T. Akin, Acting Appellate Counsel; John W. Alexander, Special Attorney, Bureau of Internal Revenue.

JWA:pg 7/17/53.

[fol. 30] IN THE TAX COURT OF THE UNITED STATES

[Title omitted]

STIPULATION OF FACTS—Filed February 14, 1955

The parties to the above styled and numbered cause now pending before the Tax Court of the United States, acting herein by and through their respective attorneys of record, hereby agree and stipulate that upon the trial of said cause the facts hereinafter set out shall be accepted as true, without any proof other than the filing of this stipulation as a part of the record in said cause; but the making and filing of this stipulation of facts shall not be or be construed as a waiver by either party of such party's right to introduce upon the trial of this cause such other and further evidence not inconsistent with the facts hereby stipulated as such party may see fit to offer. The facts so stipulated are as follows:

1

The petitioner, P. G. Lake, Inc., is a corporation chartered under the laws of Delaware with its principal office in Tyler, Smith County, Texas. It is engaged in the business [fol. 31] of producing oil and gas. Petitioner keeps its books and records and makes its income tax returns for calendar year periods and uses the accrual method of accounting. Petitioner's income and excess profits tax returns for the calendar years involved in this proceeding (1949, 1950 and 1951) were filed with the Collector of Internal Revenue for the Second Collection District of Texas, at Dallas, Texas. These returns showed the following income tax liabilities, the amounts of which were duly paid to said Collector of Internal Revenue:

For the calendar year 1949	$ 4,359.85
For the calendar year 1950	266,568.55
For the calendar year 1951	124,916.14

2

On December 29, 1950, petitioner owned the 7/8ths working interest in two commercial oil and gas leases from which it, as the operator, was then producing oil in substantial quantities. These leases are known as the Mrs. V. E. Reid Lease in Rusk County, Texas (covering 120 acres more or

less) and the Owens Lease in Gregg County, Texas (covering 290 acres more or less). Petitioner had owned these properties continuously for several years prior to December 29, 1950, and each property was held by petitioner for productive use in its trade or business of producing oil, and not for sale.

3

On said date of December 29, 1950, petitioner was indebted to P. G. Lake, its President, in the sum of $600,000. [fol. 32] On said date of December 29, 1950, petitioner, in consideration of the cancellation of said indebtedness of $600,000 by the said P. G. Lake, executed and delivered to P. G. Lake an instrument with respect to its said Reid and Owens leases, which instrument (omitting field notes of the properties involved, signatures and acknowledgments) was in words and figures as follows:

STATE OF TEXAS,
County of Smith:

Whereas, P. G. Lake, Inc., a corporation, is the owner of certain oil, gas and mineral leases located in Gregg and Rusk Counties, Texas, and briefly described as follows:

Lease No. 1

A certain oil, gas and mineral lease known as the Mrs. V. E. Reid Lease, and covering the following described property located in Rusk County, Texas, to wit:

(Field notes omitted)

Lease No. 2

A certain oil, gas and mineral lease given by J. P. Owens and wife Willie Owens to J. A. Reynolds, on August 1, 1930, and duly recorded in Volume 78, page 394, Gregg County Deed Records, and which oil and gas lease covered certain lands located in the David Meredith Survey, Abstract 131, and the Charles P. Hereford Survey, Abstract 106, located in Gregg County, Texas, the properties covered

[fol. 33] by said oil and gas lease, by a recent survey of same, being described as follows:

(Field notes omitted)

Now, therefore, know all men by these presents:

That P. G. Lake, Inc., acting herein by and through its proper officers, thereunto duly authorized by a resolution of its Board of Directors hereunto duly passed and entered, hereinafter referred to as Grantor, for and in consideration of the sum of Ten Dollars ($10) and other good and valuable consideration to it in hand paid by P. G. Lake, hereinafter referred to as Grantee, the receipt of which is hereby acknowledged, does hereby Bargain, Sell, Assign and Convey unto the said Grantee, his heirs and assigns, such an interest in said oil and gas leases, and each of them, so that the said P. G. Lake Grantee, shall own twenty-five per cent of seven-eights (25% of 7/8ths) of all oil and gas in, under or upon such leases and each of them, and shall be entitled to receive twenty-five per cent of seven-eighths (25% of 7/8ths) of all the oil, gas and other minerals produced, saved and marketed from the above described oil and gas leases and leasehold estates, from and after 7:00 a.m. January 1, 1951, until said Grantee, his heirs and assigns, shall have received by virtue of this interest the sum of Six Hundred Thousand Dollars ($600,000), net to him after the payment of all pipe line and gross production taxes attributable to said interest, plus an amount equal to interest at the rate of three per cent (3%) per annum payable monthly on the entire unpaid balance of said original sum remaining from month to month unsatisfied.

[fol. 34] The 25% of 7/8ths of the oil and gas thereby assigned to said Grantee shall be forever free and clear of any expense of developing, maintaining or operating said leasehold estates, and all costs of producing and marketing said products shall be borne by Grantor, and Grantor shall save and hold Grantee forever harmless of any such costs. Grantor shall likewise promptly pay off and discharge all ad valorem taxes that may be assessed against the interest hereby conveyed to Grantee, and the proceeds of said 25% of 7/8ths of the gross production shall be paid directly to the

said Grantee, his heirs and assigns, by any pipe line company or other purchaser of oil or gas from said premises.

The parties hereto shall, from time to time, execute such transfer orders, division orders, or instruments of like character necessary in order to carry into effect the terms and provisions of this conveyance and to facilitate the orderly handling transportation and sale of the oil and gas produced from said leases.

And when the Grantee shall have received the full net sum of $600,000 plus an amount equal to interest thereon as hereinabove provided for, from the proceeds of the sale of 25% of 7/8ths of all of the oil and gas produced and saved from the above described leases, then this conveyance shall terminate and the interest hereby assigned shall revert to and revest in the Grantor, its successors and assigns, and Grantee shall execute and deliver an instrument of reconveyance of said interest, and any such other papers as may be necessary to replace the title in Grantor.

[fol. 35] To have and to hold the above described interest unto the said P. G. Lake, his heirs and assigns, forever, subject to the terms and conditions of this conveyance.

This instrument is executed in duplicate, each of which, for the purpose of filing, shall be considered as an original. This is done to facilitate filing both in Gregg County and Rusk County.

In testimony whereof, P. G. Lake, Inc. has caused this instrument to be executed by its Vice-President, attested by the Secretary, and the corporate seal affixed thereto, this the 29th day of December, 1950.

(Signatures and Acknowledgments Omitted)

4

Following the execution and delivery of the instrument set out in the preceding paragraph by petitioner to P. G. Lake, transfer orders in the usual form were executed and delivered to the pipe line companies which were then running and purchasing the oil produced from said properties, directing the payment to P. G. Lake of the proceeds from the sale of 25% of seven-eighths of the oil and gas produced from said Reid and Owens Leases effective at 7:00 a.m. January 1, 1951, until he, the said P. G. Lake, had received oil and gas of the value specified in said instrument

above set forth. In accordance with this order, the pipe line companies purchasing said oil and gas paid P. G. Lake directly for said share of the oil and gas, beginning with [fol. 36] oil and gas produced during the month of January, 1951, and continuing until February, 1954, at which time the said P. G. Lake had received oil and gas of the value specified in the foregoing instrument. Thereupon, the rights of the said P. G. Lake under said instrument terminated, and he executed and delivered to P. G. Lake, Inc. an instrument evidencing this termination. On December 29, 1950, it could have been estimated with reasonable accuracy that it would require three years or more for the said Owens and Reid Leases to produce sufficient quantities of oil and gas so that 25% of seven-eighths thereof would have a value equal to the amount of oil and gas to which P. G. Lake was entitled under and by virtue of the foregoing instrument.

5

In its income and excess profits tax returns for the calendar year 1950, the petitioner reported the transaction summarized in the preceding paragraphs 2, 3 and 4, as a sale producing a profit of $600,000 taxable as long-term capital gain. In determining the deficiency here involved for the calendar year 1950, the respondent treated said sum of $600,000 (less $660 representing the cost of United States documentary stamps affixed to the aforesaid instrument of December 29, 1950) as ordinary income as to which depletion was allowable, with the following explanation:

> "The $599,340 represents net amount received from sale of oil payment to P. G. Lake in December 1950. The amount is reported on return as sale of capital assets. It is held to be the advance sale of oil and taxable as ordinary income in accordance with General Counsel's Memo 24849, Internal Revenue Cumulative [fols. 37-50] Bulletin 1946-1, p. 66. Depletion is allowed on this income in adjustment (d) below."

6

Throughout the years involved in this proceeding, and for many years prior thereto, the Railroad Commission of Texas had and exercised jurisdiction over oil and gas well drilling and oil and gas producing activities within the

State of Texas, including the oil and gas field known as the East Texas Oil Field, in which all of the properties hereinafter referred to were located. In the exercise of this jurisdiction, the Railroad Commission of Texas from time to time fixed the amount of oil per day and per month which could be produced from oil wells and oil and gas leases in the East Texas Oil Field, the amount of such permitted production being ordinarily referred to as the "allowable" oil production. * * *

* * * * * * *

[fol. 51] 15

On June 1, 1953 (this proceeding having been filed on May 22, 1953), petitioner caused to be transmitted to the Director of Internal Revenue at Dallas, Texas, its check in favor of said Director for the sum of $133,590.19. A true and correct copy of the letter by which said check was transmitted is attached hereto and marked Exhibit H for identification. Said check was accepted by said Director of Internal Revenue and duly deposited and collected by him on or about June 2, 1953. The proceeds of said remittance were deposited by said Director in the said Director's Suspense account No. 93-566. No notice was given to petitioner that said check had been deposited in said suspense account.

In Witness Whereof, the parties to the above styled and numbered proceeding, acting by and through their attorneys of record, have executed this stipulation in several counterparts, each of which shall be considered an original, this 9th day of February, 1955.

Harry C. Weeks, Attorney for Petitioner. (S.) R. P. Hertzog, A.T.A., Acting Chief Counsel, Internal Revenue Service, Attorney for Respondent.

[fol. 52] IN THE TAX COURT OF THE UNITED STATES

Docket No. 48684

P. G. LAKE, INC., Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

24 T. C. No. 114

Capital Gain—Oil and Gas—Undivided Interest in Minerals in Place Until Production Equalled a Stated Amount. —The petitioner realized long-term capital gain and not ordinary income when in 1950, in consideration of the cancellation of an indebtedness of $600,000, it transferred 25 per cent of 7/8ths of all oil and gas upon two leases owned by it to its creditor until such time as the payments received by the latter equalled the amount of the debt plus interest thereon.

Depletion Allowance—Oil and Gas—Substitute Royalties —Transferred Allowables.—The gross income derived by the petitioner from the operation of two oil leases was not subject, for the purpose of determining the depletion allowance under section 114(b)(3) of the Internal Revenue Code of 1939, to the exclusion of amounts paid by petitioner in 1949, 1950 and 1951 to another oil company for transferred allowables and to royalty owners of a third lease owned by petitioner as substitute royalties, as a result of which the [fol. 53] petitioner was permitted by the Railroad Commission of Texas to produce additional oil from the first two leases.

Harry C. Weeks, Esq., for the petitioner.
Paul M. Newton, Esq., for the respondent.
(Seal.)

OPINION—Filed September 20, 1955

MURDOCK, *Judge:* The Commissioner determined deficiencies in income tax of $9,060.79 for 1949, $47,459.09 for 1950 and $12,026.24 for 1951 and a deficiency in excess profits tax for 1950 of $65,044.07. Two issues are presented for decision. One is whether the petitioner realized a long-

term capital gain from the sale in 1950 of a portion of an interest in two oil and gas leases. The facts relating to this issue have been fully stipulated and the stipulation on this and the other issue is adopted, together with all exhibits, as findings of fact in this case.

The petitioner is a Delaware corporation which filed its returns for the taxable years with the collector of internal revenue for the second district of Texas. It was engaged in developing oil and gas properties and producing oil and gas.

The petitioner was indebted to P. G. Lake in the amount of $600,000 on December 29, 1950 and on that date, in consideration of the cancellation of that indebtedness, sold and transferred to him 25 per cent of 7/8ths of all oil and gas upon two leases, entitling him to receive that portion of all production from the leases beginning at 7 a.m. January 1, 1951, until he had received $600,000 net to him, plus an amount equal to 3 per cent per annum payable monthly on the unpaid balance of the $600,000. The petitioner had [fols. 54-59] owned the leases for several years prior to December 29, 1950, and had always held them for productive use in its business and not for sale. The petitioner reported the entire consideration of $600,000 as long-term capital gain on its return for 1950, but the Commissioner, in determining the deficiency, held that the $600,000, less the cost of documentary stamps affixed to the conveyance, was ordinary income subject to the allowance for depletion.

It was held that the petitioner correctly reported its gain from this transaction upon authority of the following cases which the Commissioner concedes are adverse to his contention: *Lester A. Nordan*, 22 T.C. 1132, in which the appeal of the Commissioner to the Court of Appeals for the Fifth Circuit was dismissed on June 8, 1955; *John David Hawn*, 23 T.C. 516, in which the Commissioner's appeal is now pending in the Court of Appeals for the Fifth Circuit; and *Caldwell* v. *Campbell*, 218 F. 2d 567. See also *Wm. Fleming, et al.*, 24 T.C. ÷ (7/29/55).

* * * * * * *

[fols. 60-90] Reviewed by the Court.

Decision will be entered under Rule 50.

[fols. 91-93] IN THE TAX COURT OF THE UNITED STATES

[Title omitted]

DECISION—Entered January 18, 1956

The parties filed an agreed computation on December 29, 1955, pursuant to the Court's Opinion filed September 20, 1955. Therefore, it is

Ordered and Decided, That there are overpayments in income tax for the years 1949, 1950 and 1951 in the respective amounts of $1,646.88, $110,099.16 and ",459.85, which amounts were paid after the mailing of the notice of deficiency.

J. E. Murdock, Judge. Served Jan. 19, 1956.

[fols. 94-116] Clerk's Certificate to foregoing paper omitted in printing.

[fol. 117] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 118] MINUTE ENTRY OF ARGUMENT AND SUBMISSION—December 3, 1956.

(Omitted in printing)

[fol. 119] IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 16126

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

versus

P. G. LAKE, INC., Respondent.

Petition for Review of Decision of The Tax Court of the United States (District of Texas).

OPINION—February 1, 1957.

Before Hutcheson, Chief Judge, and Holmes and Borah, Circuit Judges.

HUTCHESON, Chief Judge: This appeal by the commissioner from one of a series of adverse decisions [1] of the Tax Court presents the single question whether $600,000 received as consideration for an assignment of overrid-[fol. 120] ing oil payment interests limited to $600,000 carved out of two oil and gas leaseholds or working interests [2] is taxable to the seller as ordinary income subject to

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[1] Lake v. Commissioner, 24 T.C. 1016; Fleming v. Commissioner, 24 T.C. 818; Wrather v. Commissioner (not officially reported); Weed v. Commissioner, 24 T.C. 1025; and Slagter v. Commissioner, 24 T.C. 934 (7 Cir.)

[2] The respondent is a Delaware corporation with its principal office in Tyler, Texas, engaged in the business of producing oil and gas, and on Dec. 29, 1950, it owned the 7/8 working interest in two commercial oil and gas leases from which it, as the operator, was then, and for several years had been, producing oil in substantial quantities.

On Dec. 29, 1950, respondent was indebted to P. G. Lake in the amount of $600,000, and on that date, in consideration of the cancellation of that indebtedness, it sold and transferred to Lake "such an interest in said oil and gas leases * * so that the said P. G. Lake, Grantee, shall own twenty-five percent of seven-eighths of all oil and gas in, under or

depletion rather than, as the Tax Court held, as long term capital gains under Sec. 117 of the 1939 Internal Revenue Code.

Here vigorously assailing the decision of the Tax Court in this and the other cases, on the ground that they were [fol. 121] all based on the premise that all oil payment assignments constitutes sales of capital assets entitled to capital gains treatment under Sec. 117, and declaring, "That premise was specifically rejected in the Hawn case", the commissioner thus continues:

> "In the present case, as in some of the other appealed cases, the assignor was a leasehold owner which created the oil payment right, not just, like the taxpayer in Hawn, the owner of a larger oil payment right. For that reason, the case calls for an even more

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upon such leases and each of them, and shall be entitled to receive 25 percent of 7/8 of all the oil, gas and other minerals produced, saved, and marketed from the above described oil and gas leases and leasehold estates, from and after 7:00 a.m., January 1, 1951, until said Grantee, his heirs and assigns, shall have received by virtue of this interest the sum of $600,000 net to him * * *".

The assignment also assured that he should have a royalty owner's status, that is that his 25 percent of the 7/8 of the working interest should be free and clear of any development or production expenses.

It finally provided that after grantee had received the full net sum of $600,000, with interest as provided, from the proceeds of the sale of said 25 percent of 7/8, the conveyance shall terminate and the interest assigned "shall revert to and revest in the grantor, its successors and assigns, and grantee shall execute and deliver an instrument of reconveyance of said interest, and any such other papers as may be necessary to replace the title in grantor".

On Dec. 29, 1950, it could have been estimated with reasonable accuracy that it would require three years or more for the leases to produce oil and gas of the value in amount to which grantee was entitled in the assignment. The actual pay out period was from Jan., 1951, to February, 1954, a little over three years.

basic application of the anticipatory assignment of income rule than did Hawn. Not only that, any attempt to treat the oil payment assignment as a sale of property according to ordinary property law concepts merely confirms the conclusion that it was an anticipatory assignment of income.

"Our position here in no way conflicts with this court's decision in Caldwell v. Campbell, 218 F(2) 567 where * * * the assigned oil payment rights were carved out of royalty interests * * *".

Having thus, as he thinks, cleared the ground for an all out and unembarrassed attack on the Tax Court's ruling, the commissioner assails it: (1) as contrary to our decision in Hawn's case in that it treats as substantial an interest which, under the teachings of that decision, is insubstantial; (2) in that what was here transferred was not any part of the leasehold interest, the "property representing income producing property, the vendor's capital investment", it was a transfer merely of a right to receive future income and, under the teachings of [fol. 122] *Burnet* v. *Harmel*, 287 U.S. 22, and the Corn Products case, 350 U.S. 46-52,[3] it was not entitled to Sec. 117 preferential treatment; (3) in that, if contrary to No. (2) above, the oil payment is treated as a sale of income producing property, it had not been held for six months because it did not come into existence until the oil payment was created; and (4) in that the property sold was the oil itself and thus was property "primarily held for sale in the ordinary course of business", and specifically excluded from capital gains treatment.

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[3] "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by Sec. 117 applies to transactions in property which are not the normal source of business income. It was intended 'to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.' Burnet v. Harmel, 287 U.S. at 106.".

In reply to these contentions, respondent, insisting that all prerequisites to long term capital gains treatment, if there was a sale of "property" or "real property used in the trade or business" within Sec. 117 I.R.C. of 1939, are here present, urges upon us that whether or not there was such a sale here is ruled by *Ortiz Oil Co.* v. *Commissioner*; 102 F(2) 508 and *Caldwell* v. *Campbell*, 218 F(2) 567, and not by *Commissioner* v. *Hawn*, 231 F(2) 340.

Arguing that the first two cases treat similar transactions to these as sales, that the Hawn case is clearly distinguishable and that petitioner's arguments have heretofore been rejected by this Court in *Caldwell* v. *Campbell*, respondent points out that a glance at the table of cases [fol. 123] in commissioner's brief and in the brief of Collector Campbell in *Caldwell v. Campbell* will show that commissioner's opposing arguments here are but an expanded repetition of those advanced in that case.

Insisting that the transaction under consideration was an assignment of a part of respondent's property interests in the two leases, the respondent cites in support *Commissioner v. Fleming*, 82 F(2) 324; *Colorado Oil & Gas Co. v. Commissioner*, 118 F(2) 459; *Thomas Peckham Oil Co. v. Commissioner*, 115 F(2) 685; *Lee v. Commissioner*, 126 F(2) 825; and *Fleming v. Campbell*, 205 F(2) 549.

They recall too that the Supreme Court of the United States, this court, the Supreme Court, and the Intermediate Appeal Courts, of Texas[4] have held that oil and gas leases, royalty interests, overriding royalty interests, and oil payments are interests in land, and that the Texas courts have held that these interests, are subject to ad valorem taxes, to statute of frauds treatment as real estate, and in cases of intestacy pass as real estate.

On the commissioner's general position that oil payments carved out of working interests differ from royal-

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[4] Waggoner Estate v. Wichita County, 273 U.S. 113; Thomas vs. Perkins, 301 U.S. 655; cases cited in footnote 2 (p. 568) of Caldwell v. Campbell, 218 F(2) 565; Sheffield v. Hogg, 124 Tex. 290; 77 SW(2) 1021; Stephens County v. Mid-Kansas Oil & Gas Co., 113 Texas 160; 254 S.W. 290; W. T. Waggoner Estates v. Sigler Oil Co., 118 Texas 509; 19 SW(2) 27; Tennant v. Dunn, 130 Texas, 285.

ties so carved, respondent, quoting from *Tennant v. Dunn, supra*, at page 290:

> "The interest assigned or conveyed by the instrument is in the nature of an overriding royalty. The [fol. 124] assignment gives to Mrs. Dunn, as the reservation of an ordinary overriding royalty gives to or retains in the grantor or assignor, the right to a certain quantity of oil taken from the land, delivered as it is produced, free of charges or expenses of production or operation. * * * It is our opinion that the instrument under consideration conveys an interest in the land * * * "

points to the uniform course of decision that oil payments are in law and in fact of the same nature, indeed are identical, with royalties, except that a royalty is not limited as to duration and an oil payment is.

To commissioner's third contention that respondent did not have the requisite six months holding period for the oil payment interest conveyed, *a contention on its face requiring the wholly untenable postulate that respondent, in and by the act of conveying the oil payment, acquired it*, respondent points to its complete refutation in the stipulation that *respondent had owned and held the leases for productive use in its trade or business of producing oil and not for sale for several years prior to* Dec. 29, 1950, and to the fact that it is obvious that what respondent conveyed, and the only thing that it could convey, was a part of the estate which it acquired in the acquisition of the leases.

As to his fourth contention, that, in assigning an interest in the leases, *respondent did not assign any part of the property held by it for producing income but assigned merely the oil, the property held for sale in its daily business*, and that this must be so *because the interest of any* [fol. 125] *oil payment owner is only in the oil as personal property*, respondent quotes from the leading case of *Tennant v. Dunn, supra*, in which, after stating that the particular instrument in question in that case, which carved an oil payment out of a working or leasehold interest, *did not purport to convey oil in place*, and that the ultimate right of Mrs. Dunn was a right to a certain quantity of oil

after it was produced from the well, the same to be delivered to her free from any charges for production or operation, went on to say:

> "*It does not follow, however, that the instrument does not create an interest in land or that it evidences merely a debt to be paid out of oil produced. The oil and gas leases operated to invest the lessee with a determinable fee in the oil and gas in place.* * * * *The instrument above set out under which Mrs. Dunn claims follows the form ordinarily used by a lessee in assigning or conveying an interest in the leasehold estate.* It is not a promise to pay money. *It is not a contract for the sale and delivery of oil, as personalty after production, but it undertakes to invest the assignee, and we think it invests her, presently with a right or interest in what the assignor owned.* * * * *A part of the lessee's right or interest is assigned,* not a fractional interest in the entire leasehold estate but the absolute right, without charges for production or operation, to a fractional part of the oil as and when it is produced from a well on the leased land, until the assignee has received oil of the total value of $25,000. *The total quantity of oil to be delivered to the assignee is not a fixed fraction of the entire production and is not a cer-* [fol. 126] *tain number of barrels, but it is measured by value according to a specified standard.* (p.290) * * *"The gist of the opinion in Sheffield v. Hogg is that oil and gas royalties, whether payable in kind or in money,* * * * *should be adjudged to be present interests in land rather than merely rights in personalty at some uncertain date, because they are profits arising out of land and further because such classification, which accords with the practice in the oil and gas industry furnishes a stability highly important, if not essential to the structure of the business.* * * * (p.292.)
>
> "The fact that Mrs. Dunn's purchase of the interest was highly speculative and that she might realize either nothing or very large profits does not affect the nature of the interests. Most investments in oil properties or production are speculative. Mrs. Dunn did not become by virtue of the assignment a mining partner or a joint adventurer, *for it gave her, not merely a part of the profits of the enterprise, but an interest in land,*

free of charges for development or operation and without obligation to share in losses; and under the assignment she had no right to engage, and did not in fact engage, in the operation of the leased land or of the well. * * *" (p.294) (all emphasis supplied.)

Finally, it is respondent's position that in the light of the views above expressed, this court is bound by the settled law of the cases, including particularly *Ortiz Oil Co. v. Commissioner*, 102 F(2) 508; *Fleming v. Commissioner*, 205 F(2) 549; *Caldwell v. Commissioner*, 218 F(2) 568; and *Commissioner v. Hawn*, 231 F(2) 340; and the cases [fol. 127] they cite and rely on, to hold that the tax court was right and its judgment must be affirmed.

For the reasons hereafter stated, we find ourselves in complete agreement with these views.

Taking up the grounds put forward by the commissioner for reversal and rejecting, on the stipulated facts, note 2, *supra*, and for the reasons fully stated in *Scofield v. O'Connor*, F(2) just decided, the first ground that this court's decision in Hawn's case requires a contrary holding to that made below, we take up to consider in their turn the second, third, and fourth grounds.

These grounds, as we think we shall show, while put forward by the commissioner as presenting new and sound reasons for persisting in his contention that a sale of oil payments is not a sale of capital assets entitled to capital gains treatment, merely give a superficially new look to and faultfully reargue the old contention. This is accomplished by basing the new argument upon a series of unfounded assumptions as to, and the failure to recognize, the already settled state of the law on the matters discussed.

It is, of course, not conclusive against the commissioner's arguments put forward here for the first time in support of his unyieldingly held and persistently urged general contention, that sales of oil payments are not entitled to capital gains treatment, that they have been put forward in this form in no prior litigations or in the Tax Court in the cases under review here.

[fol. 128] It is, however, significant that the profound discovery announced and urged for the first time on this appeal, that the sale of an oil payment carved out of a working interest in its legal aspects differs from the sale

of an oil payment carved out of an oil interest, has heretofore escaped the attention of judges, lawyers, text writers, and commentators. As far as our information or observation goes, none of the many litigations arising out of or connected with oil payments, none of the decisions, state or federal, dealing with oil payments carved out of a leasehold estate and holding that they are in the nature of overriding royalties, none of the many textbooks, law reviews, or briefs which have dealt with oil payments, have drawn the distinction the commissioner now seeks to draw between oil payments carved out of leasehold interests and those carved out of royalty interests.

This significance is heightened by the fact that the commissioner, as we understand, concedes that overriding royalty interests carved out of working interests or to which working interests are subject are in nowise different from royalty interests reserved to or granted by the owner of the fee.

In short, a careful consideration of the long and involved arguments put forward in the briefs in these cases in support of the commissioner's new look and view make it plain we think that, *viewed not as proposals for legislation*, in which case wholly different considerations would apply, but as restatements of the law of the decided cases, they rest on demonstrably false premises whose discovery and exposure they cannot survive.

[fol. 129] The first of these premises is that the assignment of an oil payment carved out of a leasehold estate is not an assignment of a part of the interest conferred by the lease, a premise precisely refuted in Dunn's case.[3] This

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[3] "It does not follow, however, that the instrument does not create an interest in land or that it evidences merely a debt to be paid out of oil produced. The oil and gas leases operated to invest the lessee with a determinable fee in the oil and gas in place. * * * The instrument above set out under which Mrs. Dunn claims follows the form ordinarily used by a lessee in assigning or conveying an interest in the leasehold estate. It is not a promise to pay money. It is not a contract for the sale and delivery of oil, as personalty after production, but it undertakes to invest the assignee, and we think it invests her, presently with a right or interest in what the assignor owned. * * *"

premise repeated and affirmed over and over stems from the failure of the commissioner to understand, or his unwillingness to recognize, the nature of such an oil payment, a refusal or failure having nothing to do with the substance and reality of the transaction under review, or with the decisions in point.[6] It arises, in short, entirely out of his giving the word "payment" its dictionary meaning where used alone as the satisfaction of a debt or obligation, instead of in the phrase "oil payment" the clearly understood meaning as a part of a technical descriptive phrase used in conveying carved out interests in oil, a meaning which the decisions have ascribed to and fixed for it when used in the connection under consideration here.

[fol. 130] An examination of the many cases, federal and state, which have dealt with oil payments, shows that, without varying, the courts have treated alike oil payments whether carved out of the working or the royalty interests, and that the so-called distinction between them, which the commissioner urges here, has never been made before.

It is, we think, completely fallacious to say that an oil payment carved out of a leasehold interest stands any differently in law from an oil payment varved out of a royalty interest, and it is only by the repetition of the incorrect statement, that they do stand differently, that the argument is, or can be, called an argument.

The commissioner's new approach, therefore, that in this case, because the oil payment was carved out of a working interest, there was not a sale of income producing property, a part of the leasehold interest, but merely of oil as per-

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[6] "* * * we have directed attention to the fact that the interest assigned to Mrs. Dunn, if not in principle the same as a royalty, particularly an overriding royalty, is very like it. We believe we may take judicial knowledge of the common practice in the industry as to the method of paying royalties or other interests in oil. Many owners of royalties and like interests have no facilities for receiving oil, and the ordinary practice is that the owners of such interests, whether payable in oil or in money, obtain payment in money after executing division orders to pipe line companies or other purchasers of the oil." Tennant vs. Dunn, 130 Texas, at p. 294.

sonal property after it is produced, is seen to be in complete contradiction of the law of the cases.

Equally fallacious is the commissioner's fourth point, that, assuming that he is incorrect in contending that the sale of the carved out oil payments was not the sale of a capital asset, held for production of income but was an anticipatory sale of the income itself, what respondents sold, though a capital asset, is merely the oil itself, "property held primarily for sale", and therefore, the sale comes within the express exception from Section 117.

In the first place, the Supreme Court of Texas, in *Tennant v. Dunn, supra*, saying "*It is not a contract for* [fol. 131] *the sale and delivery of oil as personalty after production*, but it undertakes to invest the assignee, and we think it does invest her, presently with a right or interest in what the assignor owned" (emphasis supplied), expressly negatives the commissioner's contention that royalty payments are conveyances of the oil as personalty.

In the second place, it is no more sound to say that the carving out of an oil payment out of a working interest and the sale of the oil payment thus carved is a sale of the oil as personalty, than it is to say that the carving of a royalty out of a working interest and its sale is such a sale, and no one, not even the commissioner, has yet been heard to claim that the carving of a royalty out of a working interest places the owner of the leasehold estate in the position of merely selling the oil itself as personalty and, therefore, that the sale was, within the Sec. 117 exception, of property held primarily for sale. Indeed, the commissioner concedes that "an oil payment assignment may sometimes constitute the sale of a capital asset as where a person who owns only an oil payment right sells the entire right." Thus, as applied to the case at bar, though according to the commissioner the taxpayer did not sell Lake a capital asset, Lake somehow acquired one, and if he later sold the whole of what he bought, the purchaser from him would acquire a capital asset, a truly remarkable result.

The commissioner does not enlighten us on whether in the purchaser's hands the oil which Lake would receive from year to year on the wasting capital asset so acquired would be subject to depletion, but we must assume that

it would not, since, contrary not to some but to all of the cases on depletion, the commissioner has concluded here [fol. 132] that this putative capital asset was depletable in a lump sum in favor of respondent in the year of the sale, even though not a barrel of the oil had been then drawn.

Of the commissioner's third contention, that the sale was not of property held for more than six months, it is sufficient to say that the parties have stipulated, and the facts show, that the properties out of which the interest was carved had been held for more than that time and that the commissioner's contention, that the property sold came into existence with, and only with, its assignment, is contrary to legal principles indeed, is little short of legal legerdemain.

This brings us at last to what in our opinion is the crowning inconsistency of the commissioner's whole argument. This is that the government, through the commissioner, has the right and power to remake or reinterpret their contract for the parties, so that, though according to the teachings of all the cases,[7] the assignee and not the assignor of a mineral interest, under instruments like those here, is entitled to take depletion on it, the commissioner can by his intervention deprive the assignee of his contract right to depletion in the years following and require the assignor to take it all in the year of the sale before the right to it has arisen. Of course, if the instrument transferred an economic interest in the oil, the commissioner cannot do this.

The Court of Appeals for the Seventh Circuit recognized this in the Slagter case in which treating the arrangement [fol. 133] there made as a loan and a dedication of the assigned interest in the oil properties to the repayment of that loan, it is held that the assignors were taxable on the transaction not when they obtained the cash paid for the assignment but that the "income in question was taxable as ordinary income of the taxpayers (assignors) as it accumulated and was paid from time to time to Ashland, and

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[7] Some of these are: Anderson v. Helvering, 319 U.S. 404; Burnet v. Harmel, 287 U.S. 103; Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25; Caldwell v. Campbell, 218 F(2) 567; Kirby Petroleum Co. v. Commissioner, 326 U.S. 599.

that the tax liabilities should be computed for the years in question upon the amounts thus realized and paid to Ashland in the respective periods."

While we incline to the view that, in its opinion in the Slagter case, the Court of Appeals did not give full effect to the true nature of a limited overriding royalty or oil payment interest as announced in *Thomas v. Perkins*, 301 U.S. 655, *Anderson v. Helvering*, 310 U.S. 404, *Caldwell v. Campbell*, *supra*, and numerous other decisions of this court, it is not necessary for us to determine whether the case was or was not correctly decided on its facts. It is sufficient to say of it that nothing said in it or in its result gives any aid or comfort to, or in anywise supports the contention of the commissioner, as applied to the facts of this case, and that we are of the clear opinion that the decision of the Tax Court was right and should be affirmed.

[fol. 134] IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 16126

COMMISSIONER OF INTERNAL REVENUE,

versus

P. G. LAKE, INC.

JUDGMENT—February 1, 1957

This cause came on to be heard on the petition of Commissioner of Internal Revenue for a review of a decision of the said Tax Court of the United States, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby, affirmed.

[fol. 135] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 136] [Caption omitted]

[fol. 137] CAPTION

Be it remembered, that at a regular term of the United States District Court in and for the Western District of Texas, which said term began at the Austin Division on the 12th day of June, 1955, the Honorable Ben H. Rice, Jr., United States District Judge, presiding, and holding a session at San Antonio, Texas, there came on to be heard on the 4th day of November, 1955, among other causes on the docket, the following cause:

Civil Action No. 824

DENNIS M. O'CONNOR AND KATHERINE O'CONNOR, INDEPENDENT Executors of The Estate of Thomas O'Connor, Deceased, and Dennis M. O'Connor, Katherine O'Connor, Mary O'Connor Braman, Joined by her husband, D. H. Braman, and Thomas O'Connor, Jr.

versus

FRANK SCHOFIELD, Former Collector of Internal Revenue

And, afterwards, at a term of said Court which began at the said Austin Division on the 23rd day of January, 1956, and continued in session to and included the 27th day of March, 1956, judgment was rendered, at Waco, Texas, in said cause.

[fol. 138] IN THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF TEXAS, AUSTIN DIVISION

[Title omitted]

COMPLAINT

Now come the plaintiffs, Dennis M. O'Connor and Katherine O'Connor, independent executors of the Estate of Thomas O'Connor, Deceased, and Dennis M. O'Connor, Katherine O'Connor, Mary O'Connor Braman, joined herein by her husband, D. H. Braman, and Thomas O'Connor, Jr., complaining of Frank Scofield, former Collector

of Internal Revenue for the First District of Texas, and allege:

I

This is an action to recover income taxes and interest erroneously assessed and collected by the Collector of Internal Revenue for the fiscal year ended November 30, 1948. Jurisdiction is based upon the existence of a federal question in that the case arises under a law providing for internal revenue.

[fol. 139]

II

Defendant owes plaintiffs the sum of $3,613,173.03 with interest at the rate of 6% per annum on account of income taxes erroneously assessed and collected and paid by plaintiffs, as will be shown more particularly hereinafter.

III

Plaintiffs are citizens of the United States and of the State of Texas, and reside in Victoria County, Texas.

IV

The defendant, Frank Scofield, was heretofore Collector of Internal Revenue for the First District of Texas and was the Collector to whom taxes sued for in this cause were paid, and is a resident of Travis County, Texas, which is in the Austin Division of the Western District of Texas.

V

Thomas O'Connor died testate in Victoria County, Texas, on December 5, 1946. Plaintiffs, Dennis M. O'Connor and Katherine O'Connor duly qualified as independent executors of the Estate of Thomas O'Connor, Deceased, and are now acting in such capacity. Plaintiffs, Dennis M. O'Connor, Katherine O'Connor, Mary O'Connor Braman, and Thomas O'Connor, Jr., are the sole heirs at law and devisees under the will of Thomas O'Connor, deceased. D. H. Braman is the husband of Mary O'Connor Braman.

VI

Within the time prescribed by law, to-wit, on February 14, 1949, planitiffs, Dennis M. O'Connor and Katherine

O'Connor, acting as executors of the Estate of Thomas O'Connor, Deceased, executed and filed with the defendant, as Collector of Internal Revenue, a fiduciary income tax return for said estate for the fiscal year ended November [fol. 140] 30, 1948, and paid the income tax shown to be due by said return, to-wit, $8,375,485.17.

VII

In the fiscal year ended November 30, 1948, the executors of the said estate had sold certain royalty interests in a transaction hereinafter more particularly described. The cash sum received from such sale was $9,990,350.00. At that time published rulings of the Treasury Department held that sales of this character should be reported for income tax purposes as ordinary income, subject to the allowance for statutory depletion. Being so advised, the executors of said estate reported said proceeds as ordinary income, deducting on said return the 27½% depletion, amounting to $2,747,346.25 and also deducting expenses attributable to said sale amounting to $10,990.00. The net income so reported on account of said sale was $7,232,013.75. The tax paid with respect to this item amounted to $5,620,717.14. Said tax was erroneously reported and paid. Plaintiffs allege that said sale of said limited royalty interest was the sale of a capital asset held for more than six months consisting of economic interests in oil in place in Refugio County, Texas, and which constituted a part of the assets of said estate. Said sale should have been reported as the sale of capital assets held for more than six months and should have been treated as long-term capital gain, in which event the tax thereon would have been $2,007,544.11. Demand is made upon the defendant for production at the trial of this cause of the original income tax return so filed by plaintiffs, as executors of said estate, for the fiscal year ended November 30, 1948.

[fol. 141] VIII

Thereafter, on February 11, 1952, and within three years from the date of the filing of the income tax return for the year in question, plaintiffs filed a timely and proper claim for refund in the amount of $3,621,263.73. Attached hereto, marked Exhibit "A", is a photostatic copy of the

retained copy of said claim for refund. Of the amount of the refund so claimed, $3,613,173.03 represents the difference between the amount of income taxes erroneously paid by said executors on the proceeds from the sale of said capital assets and the amount of income taxes which they should have paid as the result of such sale. The remaining amount of said claim involves an item not here in question. By registered letter dated March 12, 1953, the executors were notified by the Commissioner of Internal Revenue that of the amount sought by said claim for refund, only $7,571.26 was allowed. Said letter rejected the claim in full for the amount of $3,613,173.03, involving the tax paid in connection with the sale in question. This action is brought within the time prescribed by Section 3772(a)(2) of the 1939 Revenue Code and within the time prescribed by Section 6532 of the Internal Revenue Code of 1954. Demand is made upon the defendant to produce at the trial of this cause the original claim for refund filed by the executors.

IX

The facts in connection with the executors' sale of capital assets of said estate are as follows: Decedent, Thomas O'Connor, owned considerable property and it was evident that a large amount of cash would have to be accumulated in order to pay the Federal estate and State inheritance taxes which would be due from his estate. The Federal Es- [fol. 142] tate Tax return filed by said executors with defendant on January 5, 1948, showed that Federal estate taxes in the sum of $11,511,435.32 to be due from said estate. Of this amount, the executors paid defendant $8,911,435.32 on February 27, 1948, and requested the Commissioner of Internal Revenue to grant them an extension of time within which to pay the remaining $2,600,000.00. The requested extension was granted and the executors were given until March 5, 1949, to pay said sum. On August 25, 1948, the Commissioner of Internal Revenue assessed additional estate taxes against said estate in the amount of $1,844,605.90, which said amount was duly paid by plaintiffs on September 17, 1948. At that time State inheritance taxes in the sum of $2,159,450.48 were due. This was in addition to the sum of $1,105,602.46 previously paid to the State of Texas. By this time, the executors

had sold all of the stocks, bonds, cattle, horses, ranching equipment, and all other marketable personal property belonging to said estate. The remaining assets of said estate consisted of land and reserved royalty interests in the oil, gas and other minerals under same. Various plans to raise the necessary amount of money to discharge said Federal estate and State inheritance taxes were studied and considered by said executors and they finally decided to make an outright sale of certain reserved royalty interests in the oil in place under producing mineral properties owned by said estate and located in Refugio County, Texas. Accordingly, such sale was consummated on November 26, 1948, with D. E. Blackburn of Victoria, Texas, which involved the conveyance by general warranty deed to Blackburn by plaintiffs, as executors of said estate, and also individually along with the other devisees under the will of decedent, of certain fractional royalty interests in [fol. 143] the oil in place and to be produced from certain designated tracts of land owned by said estate and located in the Tomoconnor oil field in Refugio County, Texas. The consideration paid by D. E. Blackburn to the executors for the royalty interests so conveyed to him was $9,990,350.00 in cash. Attached to this Complaint as Exhibit "B" is a photostatic copy of a certified copy of the conveyance from the executors to Blackburn. The conveyance to Blackburn contained a provision to the effect that if, as and when Blackburn received a total sum of $10,000,000.00, together with interest thereon at the rate of four per centum (4%) per annum, (to be computed as provided therein) from oil produced from the interests conveyed to him, Blackburn's interest should terminate and the remainder should revert to the grantors named in said conveyance. The sale by the executors of these capital assets was complete and final. The payment of the consideration to them in cash was unconditional and irrevocable whether or not oil continued to be produced from the properties conveyed. There was no agreement or personal obligation on the part of plaintiffs or any of them to return all or any part of the consideration received by them from the purchaser under any condition, nor was there any guarantee by plaintiffs or any of them that purchaser would receive the sum stated out of production from the properties. Neither the plaintiffs nor

the decedent have ever engaged in the business of buying and selling oil, gas and mineral leases, or oil, gas and mineral royalties or any other form of interest in oil, gas or minerals. The basis for computing gain on the sale of such oil payment, being an aliquot part of the value at decedent's death of the royalties in question, was not less than $1,949,183.15. The proceeds from the sale of said oil payment were used to pay the remaining balance due on the [fol. 144] Federal estate tax, the balance due on the State inheritance tax and the income taxes arising from such sale.

X

The sale made by plaintiffs, as executors of said estate, was the sale of present interests in oil in place under the ground owned and held by decedent as a capital asset for more than six (6) months. Under applicable law, the proceeds of such sale of real property interests, not held for sale in the ordinary course of taxpayer's business, was taxable to decedent's estate in the manner and subject to the limitations provided by law for the taxation of long-term capital gains. The disallowance of plaintiffs' claim for refund and the taxation of such gains as ordinary income, subject to depletion, is wholly contrary to law, and has resulted in plaintiffs being illegally denied a refund of said income taxes and interest thereon.

Wherefore, premises considered, plaintiffs pray for judgment against the defendant for said income taxes erroneously paid in the sum of three million six hundred thirteen thousand, one hundred seventy-three & 03/100 dollars ($3,613,173.03), together with legal interest thereon from February 14, 1949, to the date of payment, and all costs herein expended, and for such other and further relief as may be proper herein.

F. C. Proctor, J. O. Jackson, Attorneys for Plaintiffs.

[fol. 145] Robertson, Jackson, Payne, Lancaster & Walker, 2800 Republic National Bank Building, Dallas 1, Texas. Stofer, Proctor, Houchins & Anderson, 411 Victoria Bank & Trust Company Building, Victoria, Texas.

(Here follows 1 Photolithograph, side folio 146)

(see next card)

Form 843
TREASURY DEPARTMENT
Internal Revenue Service
(Revised Feb. 1949)

EXHIBIT A TO COMPLAINT

CLAIM

TO BE FILED WITH THE COLLECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID

The Collector will indicate in the block below the kind of claim filed, and fill in the certificate on the reverse.

COLLECTOR'S STAMP
(Date received)
RECEIVED
FEB 19 1952
INT. REV.
DIST. REV.

- ☐ REFUND OF TAXES ILLEGALLY, ERRONEOUSLY, OR EXCESSIVELY COLLECTED.
- ☐ REFUND OF AMOUNT PAID FOR STAMPS UNUSED, OR USED IN ERROR OR EXCESS.
- ☐ ABATEMENT OF TAX ASSESSED (not applicable to estate, gift, or income taxes).

STATE OF Texas
COUNTY OF Victoria } ss:

TYPE OR PRINT

Name of taxpayer or purchaser of stamps Estate of Thos. O'Connor

Business address 408 Victoria Bank & Trust Bldg., Victoria, Texas
(Street) (City or town, postal zone number) (State)

Residence

The deponent, being duly sworn according to law, deposes and says that this statement is made on behalf of the taxpayer named, and that the facts given below are true and complete:

1. District in which return (if any) was filed First Texas
2. Period (if for tax reported on annual basis, prepare separate form for each taxable year) from 12-1, 1947, to 11-30, 1948
3. Character of assessment or tax Income Tax
4. Amount of assessment, $8,383,662.29; dates of payment
5. Date stamps were purchased from the Government
6. Amount to be refunded $3,621,263.73
7. Amount to be abated (not applicable to income, gift, or estate taxes) $
8. The time within which this claim may be legally filed expires, under section 322(b) of I. R. C. (Revenue Act or Internal Revenue Code) on February 15, 1952.

-10-

3. Character of assessment or tax Income Tax
4. Amount of assessment, $8,383,662.29; dates of payment
5. Date stamps were purchased from the Government
6. Amount to be refunded $3,621,263.73
7. Amount to be abated (not applicable to income, gift, or estate taxes) $
8. The time within which this claim may be legally filed expires, under section 322(b) of I. R. C. (Revenue Act or Internal Revenue Code) on February 15, 1952.

-10-

The deponent verily believes that this claim should be allowed for the following reasons:

Proceeds from sale of oil payments should have been treated as long-term capital gain realized on the sale of a capital asset.

In computing the tax liability the percentage limitations provided in Sections 12(9) and 12(c)(2) should not be applied to net long-term capital gains, but should be applied to ordinary income only; whereas the limitations provided in Sections 117(c)(2) should be applied to the long-term capital gain.

182136

(Attach letter-size sheets if space is not sufficient)

Subscribed and sworn to before me this 14th day of January, 1952

E. F. Bergner
(Signature of officer administering oath)

(Title)

Signed Jno. M. O'Connor Executor
Katherine E. Connor Executor
(SEE ATTACHED SHEET ALSO)

(SEE INSTRUCTIONS ON REVERSE)

16—18804-4

146 L. [illegible]

3-11

pany now running the oil from the above described premises, the grantee shall be entitled to receive only such oil as is run after twelve (12) midnight on November 30, 1948.

All the terms and conditions of this conveyance shall inure to and be binding upon the heirs, administrators, executors, successors and assigns to each of the parties hereto.

To have and to hold the royalty interest hereby conveyed unto the said D. E. Blackburn, his heirs and assigns, subject to the terms and provisions of said oil and gas leases and the terms and provisions of this conveyance, and the grantors, and each of them, do hereby bind themselves, their heirs, executors and administrators, to warrant and forever defend all and singular the said royalty interest unto the said D. E. Blackburn, his heirs and assigns, against every person whomsoever lawfully claiming or to claim the same or any part thereof.

In Testimony whereof witness our hands this 26th day of November, 1948.

[fol. 157] Dennis M. O'Connor, Individually and as Independent Executor of the Estate of Thomas O'Connor, deceased.

(Int. Rev. Stamps Attached and Cancelled $10,990.00)

Katherine O'Connor, Individually and as Independent Executrix of the Estate of Thomas O'Connor, deceased. Mary O'Connor Braman, D. H. Braman, Thomas V. O'Connor.

STATE OF TEXAS,
County of Victoria:

Before me, the undersigned authority, on this day personally appeared Dennis M. O'Connor, Independent Executor of the Estate of Thomas O'Connor, deceased, known to me to be the person whose name is subscribed to the foregoing instrument, and acknowledged to me that he executed the same for the purposes and consideration therein expressed both individually and in the representative capacity therein stated.

Given under my hand and seal of office this 26th day of November, 1948.

Louise Ernst, Notary Public in and for Victoria County, Texas. (Seal.)

STATE OF TEXAS,
County of Victoria:

Before me, the undersigned authority, on this day per-
[fol. 158] sonally appeared Katherine O'Connor, a feme sole, Independent Executrix of the Estate of Thomas O'Connor, deceased, known to me to be the person whose name is subscribed to the foregoing instrument, and acknowledged to me that she executed the same for the purposes and consideration therein expressed both individually and in the representative capacity therein stated.

Given under my hand and seal of office this 26th day of November, 1948.

Louise Ernst, Notary Public in and for Victoria County, Texas. (Seal.)

STATE OF TEXAS,
County of Victoria:

Before me, the undersigned authority, on this day personally appeared D. H. Braman, and Mary O'Connor Braman, husband and wife, both known to me to be the persons whose names are subscribed to the foregoing instrument, and acknowledged to me that they each executed the same for the purposes and consideration therein expressed, and the said Mary O'Connor Braman, wife of the said D. H. Braman, having been examined by me privily and apart from her husband, and having the same fully explained to her, she, the said Mary O'Connor Braman, acknowledged such instrument to be her fact and deed, and declared that she had willingly signed the same for the purposes and consideration therein expressed, and that she did not wish to retract it.

Given under my hand and seal of office this 26th day of November, 1948.

[fol. 159] Louise Ernst, Notary Public in and for Victoria County, Texas. (Seal.)

[fol. 147] We, Katherine O'Connor, Dennis M. O'Connor, Mary O'Connor Braman, and Tom O'Connor, Jr., each individually join in the foregoing claim as heirs at law of the said Thomas O'Connor, deceased.

In testimony whereof witness our hands this 14th day of January, 1952.

Katherine O'Connor, Dennis M. O'Connor, Mary O'Connor Braman, Tom O'Connor, Jr.

[fol. 148]

Estate of Thomas O'Connor

Claim for Refund

Fiscal Year Ended November 30, 1948

		Ordinary Income	Capital Gain
Net income per R A R dated 11-20-51		10,757,837.19	29,177.98
Proceeds from sale of oil payment erroneously treated as ordinary income (Net of Depletion)		(7,232,013.75)	
Long-term capital gain on sale of oil payment:			
Sales price	9,990,350.00		
Expense of Sale	10,990.00		
Net Sales Price	9,979,360.00		
Basis (Computed below)	1,949,183.55		
Profit on Sale	8,030,176.45		
Long-term capital gain			4,015,088.23
Net Income Corrected		3,525,823.44	4,044,266.21

Basis in Oil Payment Sold:

	Barrels	Basis Per Estate Tax Report Dated 6-18-48*	Total
Thos. O'Connor "A" Lease	365,785	.537205	196,501.53
Thos. O'Connor "C" Lease	788,022	.378308	298,115.03
Nordan and Morris Lease	344,236	.517045	177,985.50
L. A. Nordan "A" Lease	588,676	.544628	320,609.43
L. A. Nordan "B" Lease	.....	.....	.....
Copano "A" Lease	267,265	.575576	153,831.32
Copano "B" Lease	688,317	.728326	501,319.17
Copano "E" Lease	987,683	.304573	300,821.57
	4,029.984		1,949,183.55

* See also R A R dated 7-24-50, covering fiscal year ended 11-30-47.

STATE OF TEXAS,
County of Victoria:

Before me, the undersigned authority, on this day personally appeared Thomas V. O'Connor, known to me to be the person whose name is subscribed to the foregoing instrument, and ackpowledged to me that he executed the same for the purposes and consideration therein expressed.

Given under my hand and seal of office this 26th day of November, 1948.

Louise Ernst, Notary Public in and for Victoria County, Texas. (Seal.)

Filed for record the 26th day of November, A. D., 1948, at 5:00 o'clock P. M.

Recorded this the 1st day of December, A. D., 1948, at 9:45 o'clock A. M.

Bettie Adkins, Clerk, County Court, Refugio County, Texas, by Jewel Berry, Deputy.

[fol. 160] THE STATE OF TEXAS,
County of Refugio:

I, Bettie Adkins, Clerk of the County Court of Refugio County, Texas, do hereby certify that the above and foregoing is a true and correct copy of Royalty Deed from Dennis M. O'Connor, et al. to D. E. Blackburn, as the same appears of record in Volume 71, Pages 208-211, Deed Records of Refugio County, Texas.

To Certify, Witness my hand and seal of office at office in Refugio, Texas, this the 3rd day of February, A. D., 1955.

Bettie Adkins, Clerk, County Court, Refugio County, Texas, by Catherine Talman, Deputy. (Seal.)

Filed: March 4, 1955.

[fol. 161] IN UNITED STATES DISTRICT COURT

ORDER EXTENDING TIME FOR FILING ANSWER—May 4, 1955

On motion of the defendant in the above entitled and numbered cause,

[fol. 149] Estate of Thomas O'Connor

Computation of Tax

Fiscal Year Ended November 30, 1948

Computation at 1947 Rates:	
Net Income per schedule:	
Ordinary Net Income	3,525,823.44
Long-Term Capital Gain	4,044,266.21
Net Income	7,570,089.65
Less: Exemption	500.00
Balance	7,569,589.65
Combined tentative normal tax and surtax	6,863,146.58
Less: 5% of tentative tax	343,157.33
Combined normal tax and surtax	6,519,989.25
Alternative Tax:	
Net Income	7,570,089.65
Less: Long-Term Capital Gain	4,044,266.21
Ordinary Net Income	3,525,823.44
Less: Exemption	500.00
Balance	3,525,323.44
Combined tentative normal tax and surtax	3,182,864.33
Less: 5%	159,143.22
Balance	3,023,721.11
Limited to 85½% of $3,525,823.44	3,014,579.04
Tax on Capital Gain	2,022,133.11
Alternative Tax	5,036,712.15
Tax Assessable under 1947 Law	5,036,712.15

It is ordered that the time for filing answer in this cause be, and the same is hereby, extended for the period of sixty (60) days from May 13, 1955.

Entered this the 4 day of May, A. D. 1955, at San Antonio, Texas.

Ben H. Rice, Jr., United States District Judge.

[fol. 162] In United States District Court

Answer—Filed May 11, 1955

Now comes the defendant by and through his attorney of record, Russell B. Wine, United States Attorney in and for the Western District of Texas, and for his answer would respectfully show unto the Court as follows:

I

Defendant denies the allegations contained in paragraph 1 of plaintiffs' complaint except it is admitted that this law suit is brought by the plaintiffs to recover income taxes and interest for the fiscal year ended November 30, 1948; it is further admitted that this Court has jurisdiction of the case.

II

Defendant denies the allegations contained in paragraph 2 of plaintiffs' complaint.

III

Defendant admits the allegations contained in paragraph 3 of plaintiffs' complaint.

IV

Defendant admits the allegations contained in paragraph 4 of plaintiffs' complaint.

V

Defendant admits the allegations contained in paragraph 5 of plaintiffs' complaint.

[fol. 163]

VI

Defendant admits the allegations contained in paragraph 6 of plaintiffs' complaint.

[fol. 150] Estate of Thomas O'Connor

Computation of Tax
(Continued)

Computation at 1948 Rates:	
Net Income	7,570,089.65
Less: Exemption	600.00
Balance	7,569,489.65
Combined Tentative Normal Tax and Surtax	6,863,055.58
Less: $12,020 plus 9.75% of $6,763,055.58	671,417.92
Balance	6,191,637.66
Alternative Tax:	
Net Income Less Exemption	7,569,489.65
Less: Long-Term Capital Gain	4,044,266.21
Balance	3,525,823.44
Combined Tentative Normal Tax and Surtax	3,183,319.33
Less: $12,020 plus 9.75% of $3,083,319.33	312,643.63
Balance	2,870,675.70
Limited to 77% of $3,525,823.44	2,714,884.05
50% of Long-Term Capital Gain	2,022,133.11
Alternative Tax	4,737,017.16
Tax Assessable Under 1948 Law	4,737,017.16
Tax Assessable and Refund Claimed:	
31/366 of $5,036,712.15	426,606.75
335/366 of $4,737,017.16	4,335,791.81
Total Tax Assessable	4,762,398.56
Tax Previously Assessed	8,383,662.29
Refund Claimed	3,621,263.73

VII

Defendant denies the allegations contained in paragraph 7 of plaintiffs' complaint except it is admitted that in the income tax return for the fiscal year ended November 30, 1948, plaintiffs reported a transaction in respect of certain oil payment rights and in respect of such transaction included in the gross income for the fiscal year ended November 30, 1948, the amount of $9,990,350; it is further admitted that from this amount which was reported as ordinary income there was deducted on said tax return. the 27½% depletion which amounted to $2,747,346.25.

VIII

Defendant denies the allegations contained in paragraph 8 of plaintiffs' complaint except it is admitted that on September 13, 1952, plaintiffs filed a claim for refund in the amount of $3,621,263.73; it is further admitted that attached to the complaint as Exhibit A is a photostat copy of said claim for refund, but each and every allegation and conclusion contained in said claim is specifically denied; it is further admitted that by rejection letter dated March 12, 1953, the executors were notified by the Commissioner of Internal Revenue that the said claim for refund was rejected in full for the amount of $3,613,173.03.

IX

Defendant is without knowledge or information sufficient [fol. 164] to form a belief as to the truth of the allegations contained in paragraph 9 of the complaint except it is denied that a sale of certain royalty interests in Refugio County, Texas, was made; it is admitted that $9,990,350 was received by plaintiffs in respect of a transaction entered into with one B. E. Blackburn; it is further admitted that attached to the plaintiffs' complaint as Exhibit B is a purported photostat copy of a purported conveyance from the plaintiffs to Blackburn; it is further denied that the plaintiffs and the decedent have never engaged in the business of buying and selling oil, gas, and mineral leases, or oil, gas, and mineral royalties.

[fol. 151] February 11, 1952

Mr. Clyde Dabbs, Deputy Collector,
Bureau of Internal Revenue,
Victoria, Texas.

Dear Mr. Dabbs:

Attached hereto are claims for refunds, Forms 843, executed by the following individuals, covering the years and for the amounts shown:

Mrs. Kate S. O'Connor—Cal. 1948	$11,303.68
Mrs. Kate S. O'Connor—Cal. 1949	$11,848.49
Dennis O'Connor & Wife (Dorothy H.)—Cal. 1948	$17,016.01
Dennis O'Connor & Wife (Dorothy H.)—Cal. 1949	$15,610.97
Tom O'Connor, Jr. & Wife (Junie B.)—Cal. 1948	$17,016.03
Tom O'Connor, Jr. & Wife (Junie B.)—Cal. 1949	$15,610.95
D. H. Braman & Wife (Mary O'Connor)—Cal. 1948	$17,016.01
D. H. Braman & Wife (Mary O'Connor)—Cal. 1949	$15,610.95
Estate of Thos. O'Connor—F. Y. 11-30-48	$3,621,263.73

Please acknowledge receipt of the inclosed claims by signing the attached copy of this letter.

Yours truly, Melvin L. Roloff.

MLR/ge

Received by Clyde A. Dabbs, February 11, 1952.

[fol. 152] Exhibit "B" to Complaint

State of Texas,
County of Refugio:

Know all men by these presents: That we, Dennis M. O'Connor, of Refugio County, Texas, individually and as independent executor of the estate of Thomas O'Connor, deceased, Katherine O'Connor, a feme sole, individually and as independent executrix of said estate, Mary O'Connor Braman, joined herein by her husband D. H. Braman, and Thomas V. O'Connor, all of Victoria County, Texas, for and in consideration of the sum of Ten Dollars ($10.00) and other valuable considerations to us in hand paid by D. E. Blackburn, of Victoria County, Texas, the receipt of which is hereby acknowledged and confessed, have granted,

X

Defendant denies the allegations contained in paragraph 10 of plaintiffs' complaint.

Wherefore, premises considered, defendant prays for judgment against the plaintiffs and, asks that the complaint be dismissed with prejudice, and for such other and further relief to which he may be entitled.

Russell B. Wine, United States Attorney.

[fol. 165] In United States District Court

Stipulation of Facts—Filed November 4, 1955

The parties to the above-entitled action, through their respective attorneys, do stipulate and agree that the facts hereinafter stated are true and correct and that this stipulation may be offered in evidence without objection, subject to the right of either of the parties to this action to introduce other and additional evidence not inconsistent with the facts herein stipulated.

I

Thomas O'Connor died testate in Victoria County, Texas, on December 5, 1946. Plaintiffs, Dennis M. O'Connor and Katherine O'Connor duly qualified as independent executors of the Estate of Thomas O'Connor, Deceased, and are now acting in such capacity. Plaintiffs, Dennis M. O'Connor, Katherine O'Connor, Mary O'Connor Braman, and Thomas O'Connor, Jr. are the sole heirs at law and devisees under the will of Thomas O'Connor, deceased. D. H. Braman is the husband of Mary O'Connor Braman.

II

Attached hereto as Exhibit 1 is a photostatic copy of the instrument executed by plaintiffs as executors of the Estate of Thomas O'Connor, Deceased, and also individually, as devisees under the Will of Thomas O'Connor, which instrument evidences a transaction with D. E. Blackburn of Victoria, Texas. The instrument was delivered to D. E.

bargained, sold, transferred, assigned and conveyed, and by these presents do grant, bargain, sell, transfer, assign and convey unto the said D. E. Blackburn, the following described properties situated in Refugio County, Texas.

1. One-sixteenth (1/16) royalty interest (being 1/16 of 8/8) of all oil produced, saved and marketed from that certain 4,000 acre tract of land described in that certain Designation Agreement executed by Quintana Petroleum Company, dated March 20, 1934, and recorded in Vol. 27 at page 513 of the Deed Records of Refugio County, Texas, to which said Agreement and the record thereof reference is here made for a more complete description of said 4,000 acre tract of land; said tract of land is subject to that certain oil, gas and mineral lease executed by Thomas O'Connor, as lessor, to Quintana Petroleum Com-
[fol. 153] pany, as lessee, dated January 19, 1934, and recorded in Vol. 21 at page 17 of the Deed Records of Refugio County, Texas, and known as Quintana "A" Lease.

2. One-fourth (¼) royalty interest (being ¼ of 8/8) of all oil produced, saved and marketed from that certain 1076.26 acre tract of land described in and subject to that certain oil, gas and mineral lease executed by Thomas O'Connor, as lessor, to Quintana Petroleum Cospany, as lessee, dated April 22, 1935, and recorded in Vol. 33 on pages 343-348 of the Deed Records of Refugio County, Texas, and known as Quintana "C" Lease.

3. One-half (½) royalty interest (being ½ of 8/8) of all oil produced, saved and marketed from that certain 200 acre tract of land described in and subject to that certain oil, gas and mineral lease executed by Thomas O'Connor, as lessor, to Copano Oil Company, as lessee, dated April 20, 1938, and recorded in Vol. 39 on pages 505-509 of the Deed Records of Refugio County, Texas, and known as Copano "A" Lease.

4. Three-eighths (⅜) royalty interest (being ⅜ of 8/8) of all oil produced, saved and marketed from that certain 670 acre tract of land, 410 acres of which is described in and subject to that certain oil, gas and mineral lease executed by Thomas O'Connor, as lessor, to Copano Oil Company, as lessee, dated July 25, 1938, and recorded in Vol. 40 on pages 570-575 of the Deed Records of Refugio County, Texas; 160 acres of which is described in and subject to

that certain Supplemental Lease Contract executed by Thomas O'Connor, as lessor, to Copano Oil Company, as lessee, dated September 26, 1938, and recorded in Vol. 41 on pages 237-239 of the Deed Records of said County; the remaining 100 acres of which is described in and subject to [fol. 154] that certain Supplemental Lease Contract executed by Thomas O'Connor, as lessor, to Copano Oil Company, as lessee, dated November 5, 1938, and recorded in Vol. 42 on pages 55-57 of the Deed Records of said County; said 670 acre tract being known as Copano "B" Lease.

5. One-fourth (¼) royalty interest (being ¼ of 8/8) of all oil, produced, saved and marketed from that certain 1,754.86 acre tract of land described in and subject to that certain oil, gas and mineral lease executed by Thomas O'Connor, as lessor, to Copano Oil Company, as lessee, dated July 31, 1946, and recorded in Vol. 61 on pages 216-220 of the Deed Records of Refugio County, Texas; said 1,754.86 acre tract being known as Copano "E" Lease.

6. One-half (½) royalty interest (being ½ of 8/8) of all oil produced, saved and marketed from that certain 234.52 acre tract of land described in and subject to that certain oil, gas and mineral lease executed by Thomas O'Connor, as lessor, to L. A. Nordan and John Morris, as lessees, dated April 28, 1937, and recorded in Vol. 38 on pages 219-223 of the Deed Records of Refugio County, Texas, and known as Nordan and Morris Lease.

7. One-half (½) royalty interest (being ½ of 8/8) of all oil produced, saved and marketed from that certain 80 acre tract of land described in and subject to that certain oil, gas and mineral lease executed by Thomas O'Connor, as lessor, to L. A. Nordan, as lessee, dated August 11, 1937, and recorded in Vol. 38 on pages 226 et seq. of the Deed Records of Refugio County, Texas, and known as Nordan "A" Lease.

8. One-half (½) royalty interest (being ½ of 8/8) of all oil produced, saved and marketed from that certain 310 acre [fol. 155] tract of land described in and subject to that certain oil, gas and mineral lease executed by Thomas O'Connor, as lessor, to L. A. Nordan, as lessee, dated December 15, 1937, and recorded in Vol. 38 on pages 270-274 of the Deed Records of Refugio County, Texas, and known as Nordan "B" Lease.

Blackburn and duly recorded in the Deed Records of Refugio County, Texas.

III

D. E. Blackburn paid to the plaintiffs in the transaction [fol. 166] on the date of the delivery of the instrument (Exhibit 1) the sum of $9,990,350. The transaction evidenced by Exhibit 1 was carried out in accordance with its terms. Blackburn received the money from the companies running the oil from the properties pursuant to transfer orders executed by plaintiffs to the respective pipeline companies. Copies of the transfer orders are attached as Exhibit 2 and made a part hereof.

IV

Within the time prescribed by law, to-wit, on February 14, 1949, plaintiffs, Dennis M. O'Connor and Katherine O'Connor, acting as executors of the Estate of Thomas O'Connor, Deceased, executed and filed with the defendant as Collector of Internal Revenue, the fiduciary income tax return for the estate for the fiscal year ended November 30, 1948, and paid the tax shown to be due thereon, to-wit $8,375,485.17. In this return, in accordance with published rulings of the Treasury Department, the executors of the estate reported the proceeds from the transaction above described in the amount of $9,990,350.00 as ordinary income, deducting, however, on said income tax return the 27½% depletion amounting to $2,747,346.25 and also deducting expenses attributable to said sale amounting to $10,990.00. The net income so reported on account of said transaction was $7,232.013.75.

V

Thereafter, on February 13, 1952, and within three years from the date of the filing of the income tax return for the year in question, plaintiffs filed a timely claim for refund in the amount of $3,621,263.73. Attached hereto, marked Exhibit 3, is a photostatic copy of the said claim for [fol. 167] refund. This copy is a true and correct copy of the original claim filed with the Collector of Internal Revenue.

VI

As a result of the claim for refund an overassessment in the amount of $8,950.26 plus interest of $435.13 was re-

funded on schedule dated February 2, 1953. Of the $8,950.26 refunded, $7,571.26 consisted of overpayment in tax, and the remaining $1,379 consisted of deficiency interest. By registered letter dated March 12, 1953 the executors were notified that the claim for refund was rejected to the extent not previously allowed.

VII

If the gain from the transaction in question is properly taxable as income from the sale of a capital asset held for more than six months, and not as ordinary income, the basis for computing such gain is $1,925,105.81.

VIII

Exhibit 1 provided that, after the properties described therein had produced to Blackburn the sum of $10,000,000.00 (with interest as cumputed thereon at 4% per annum), the properties would revert to the grantors. The aforesaid amount (together with interest) was duly received by Blackburn from said properties during the period beginning January 28, 1949 and ending December 24, 1951. Upon receipt of this amount, Blackburn, pursuant to the provisions of the instrument, executed a release in favor of the estate, which said release was duly recorded in the Deed Records of Refugio County, Texas. Attached hereto marked Exhibit 4, is a copy of said release executed by Blackburn.

[fol. 168] IX

Attached hereto, marked Exhibit 5, is a schedule showing the number of barrels produced from the properties, from and after the transaction in question; the amount of dollars received by Blackburn in each of the years, 1949, 1950 and 1951 and the average price received for each barrel of oil so produced. At the date of the transaction aforesaid, in accordance with information then available to the executors of the estate and to Blackburn, and based upon prices then being received for oil, the parties had reason to believe that the properties described in the instrument had a value substantially in excess of the amount paid by Blackburn and that the properties described in said instrument would produce, over their life, sums substantially in excess of the $10,000,000.00 figure referred to in the in-

The Royalty Interests hereinabove described and conveyed shall terminate, and the title thereto shall revert and re-vest in the grantors herein whenever there shall have been delivered to the credit of the grantee an amount of oil, if, as and when produced, free of all costs, which, valued at the price paid therefor by the purchasers of said oil at the time when sold and delivered off the premises, shall equal in value the sum of Ten Million Dollars ($10,000,00.00) together with interest computed as hereinafter provided. Said interest shall be computed at the rate of four per centum (4%) per annum from the date hereof on the unrealized balance of said Ten Million Dollar ($10,000,000.00) oil payment remaining after each month's credit of the proceeds received from the sale of said oil is made. Said monthly credit shall be made as of the date grantee receives payment from the pipe line company or companies purchasing said oil, and shall be the net amount remaining after first deducting from said payments an amount equal to interest at the rate of four per centum (4%) per annum on the unrealized balance of said $10,000,00.00 oil payment computed over the period intervening since the previous credit was made.

It is expressly provided that the royalty interest herein conveyed shall be free and clear of all operating and production costs, and free and clear of all taxes (except income taxes, if any, payable by grantee), and that grantee shall be entitled ultimately to receive the net amount of oil herein conveyed without deduction for said taxes, nevertheless, [fol. 156] in remitting the monthly proceeds realized from the sale of oil the pipe line company or companies receiving such oil shall be authorized to deduct current gross production taxes and regulation pipe line taxes from such proceeds.

It is expressly agreed that this conveyance is made subject to the terms and provisions of all existing oil and gas leases covering the above described premises, and that except as to the right to receive the royalties herein conveyed grantors reserve and retain all the rights, powers and privileges, express or implied, now owned and possessed by them as lessors in such leases.

It is agreed that while this instrument shall be effective as of this date, yet, for the convenience of the pipe line com-

strument, together with interest as computed thereon at 4% per annum. Attached hereto, marked Exhibit 6, is a schedule showing the barrels produced and the volume and amount received from each particular property described in the instrument during the years 1944 to 1948, inclusive. This schedule also shows the average price received per barrel from said described properties. On November 26, 1948, based upon agreements reached with Government Engineers in connection with settlement of the estate tax liability of Thomas O'Connor, deceased, it is estimated that there were approximately 23,150,000 barrels of recoverable oil in place under the properties in question; and that after Blackburn had recovered the Ten Million Dollars ($10,000,000.00) and interest as aforesaid, it is estimated that there were approximately 19,150,000 barrels of recoverable oil in place under said properties.

[fol. 169]

X

The amount received by the estate from D. E. Blackburn was not used for the development of this or any other oil property, nor was said sum pledged, earmarked or agreed to be used in connection with any such development.

XI

Attached hereto, marked Exhibit 7, is a photostatic copy of the fiduciary income tax return filed by the executors of the estate for the fiscal year ending November 30, 1948.

F. C. Proctor, J. Paul Jackson, Attorneys for Plaintiffs. Russel B. Wine, United States Attorney, by Lonny J. Zwiener, Asst. U. S. Attorney.

(Note: Exhibits Omitted.)

[fol. 170] IN UNITED STATES DISTRICT COURT

Court Reporter's Transcript

APPEARANCES:

Mr. Jackson, Attorney for Plaintiffs.
Messrs. Mehaffy and Stroud, Attorneys for Defendant.

Morning Session

Friday, November 4th, 1955

The Court: Are you ready to proceed, gentlemen?
Mr. Mehaffy: Yes, sir.
The Court: Is the rule invoked?
Mr. Jackson: We don't care to.
The Court: Then they may resume their seats when they are sworn.

(All witnesses present in courtroom were then sworn by the Clerk.)

The Court: All right. You may go ahead.

OPENING STATEMENT

Mr. Jackson: If the Court please, this is an income tax case involving the return for the year 1951. It simply—the issue involved is simply whether or not the sale by the O'Connor Estate of certain producing papers, or certain [fol. 171] royalties, of a limited nature, royalties, which upon the payment of some ten million dollars with interest thereon at four per cent, after which time it would revert back to the Estate, whether that sale was the sale of a capital asset subject to capital gains treatment, or whether it is ordinary income to the Estate.

And, very briefly, the facts are that Ton O'Connor died in 1947 leaving a will, leaving a widow and three heirs; two sons and a daughter. The daughter is married. And those parties are all before the Court as plaintiffs here.

His will appointed his son, Dennis O'Connor, and his wife, Katherine O'Connor, independent executors of his Estate. And among the assets of the Estate were certain royalties that Tom O'Connor owned at the time of his death.

Two years after his death, in order to pay the unpaid balance owed on a very large Federal Estate Tax, and the very large balance due the State of Texas on Inheritance Taxes, the executors of the Estate proceeded, by instruments which will be stipulated, to sell to one D. E. Blackburn this royalty for $9,990,000.00 in cash; this royalty, under the instrument, to be transferred to Blackburn until such time Blackburn from the proceeds thereof had derived the ten million dollars plus interest on such ten million dollars at the declining rate of four per cent per annum. Blackburn paid the executors of the Estate ten million dollars, which funds were used to pay unpaid taxes.
[fol. 172] The question is simply whether that sale gives rise to capital gains treatment, or to ordinary income treatment.

Pursuant to the ruling of the Bureau at the time, the executors of the Estate paid the taxes in accordance with the then existing bureau ruling; they reported the amount received at ordinary income rates and paid the taxes at the ordinary rate. Thereafter, and in due time, they filed claims for refund, asking recovery of part of the payment on the ground that they should have been taxed on capital gains rates. That claim was in due course rejected by the Commissioner, and this suit ensued. I might say that in connection with the sale to Blackburn, the evidence will show that the sale was a bona fide sale, that the purpose of the sale was to raise money to pay taxes, and there was no agreement with Blackburn pertaining to guaranty of payment; it was a sale of certain mineral interests in the properties in Texas. If the Court please, we have stipulated most of the facts. We will call two witnesses somewhat later.

The Court: Is the stipulation reduced to writing?

Mr. Jackson: The stipulation has been reduced.

The Court: Mr. Mehaffy.

Opening Statement

Mr. Mehaffy: If it please the Court, Mr. Ethan B. Stroud and I are attorneys for the Tax Division of the Department of Justice, we are representing the Government in this case. Mr. Jackson has made a fair statement of the facts, with one thing included, in the stipulation, that no part of the

funds was pledged or used or agreed to be used for the development of their or any other oil properties. The issue is, and Mr. Jackson's statement also, whether or not the gains from the transaction is entitled to capital gains treatment as a sale of capital assets, assets held for more [fol. 173] than nine months, or whether it is taxable as ordinary income as it was reported on the original fiduciary return for the Estate. The Government's position is simply that in the first place there was no sale of the capital assets; there was an assignment of income only; and, second, that if the property is of such character that it can be broken into segments, and the segments having the characteristics of the whole, then it could be held to be a sale of a part of the property itself. Still it is our position that the assignment or the transfer was of such insubstantial nature, so far as it refers to the transaction in itself, that there is no sale of capital assets. In other words, ten million dollars plus four per cent interest, computed according to the terms of the instrument, made out in this case at 36 months, and our position is that, and the decision in other cases, that it is within the line of cases holding that it is simply an allotment to another person of income, which had it been received by the Estate, would have been taxable as ordinary income.

Mr. Jackson: Your Honor, at this time, and before calling witnesses, I would like to have permission to file as part of the record the agreed stipulation of the parties in this case. I think it might help the Court if I might run over the basic points in the stipulation. It is agreed, first, that Thomas O'Connor died testate in Victoria County in 1946; and that the plaintiffs here, Dennis O'Connor and Katherine O'Connor, are duly qualified as independent executors and that they are now acting in that capacity; that the plaintiffs, Dennis O'Connor and Katherine O'Connor and Mary O'Connor Breland and Thomas O'Connor are the sole heirs of Tom O'Connor, deceased, and that T. H. Breland is the husband of Mary O'Connor Breland. Now, we have attached here as Exhibit No. 1 a photostatic copy of the [fol. 174] instrument which is in question. This is the instrument executed by the plaintiffs as executors of the Estate and independently as heirs of the Estate, which instrument is a contract with Blackburn for and in consider-

ation of the sum of ten million dollars and other valuable considerations in hand paid by Blackburn, receipt of which is hereby acknowledged, have granted, warranted, sold, transferred, assigned, and by these presents do grant, warrant, transfer, assign, and convey to Blackburn the following described properties. The properties are set out. In Refugio County, Texas. It goes on to define by description certain royalty interests, the one-sixteenth of eight-eight-s in one instance, one-fourth of eight-eighths in another, in certain described lands, which I need not go into at this time. There are three pages of those descriptions and definate royalty interests. It then provides that the royalty interests hereinabove described and conveyed shall terminate and title thereto shall be reverted and reinvested in the grantors whenever there shall have been delivered to the credit of the grantee here in the amount of oil herein set forth, and produced free of all costs, or the value of the price therefor, at the time when sold and delivered off the premises, shall equal the value of ten million dollars together with interest compounded at four per cent per annum, and after providing interest on the unrealized balance of said ten million dollars remaining after each month's dividends, or proceeds, from said oil is received—as of the date grantee receives payment from the pipeline company or person purchasing said oil, and shall be the net amount remaining after first deducting from said payment an amount equal to interest at the rate of four per cent per annum on the unrealized balance of ten million dollars oil payment over the period computed intervening between the time of expiration and the time previous credits were made. Then it provides [fol. 175] that if, as and when the oil payment has been concluded, that when the assignee has received the full amount, this property will revert back, or the assignment will be reconveyed, the property, to the grantors. It is signed and acknowledged, and was duly recorded in the Deed Records of Refugio County. Now, it is stipulated in connection with this transaction D. E. Blackburn paid to the plaintiffs on the date of the delivery of the instrument, the sum of nine million nine hundred thirty thousand three hundred fifty dollars, and it is further stipulated that the transaction was carried out in accordance with the terms: Blackburn received the money from the pipeline company

running the oil from the property pursuant to the transfer orders executed by the plaintiffs to the particular pipeline companies, and copies of those transfer orders are also attached as exhibits to this stipulation. It is further agreed that within the time prescribed by law, that is on February 14th, the plaintiffs, as executors and as individuals, filed with the defendant collector of Internal Revenue a deficiency return for the Estate for the fiscal year ending November 30, 1948, and paid taxes thereon shown to be due, to-wit: One million three hundred seventy-five thousand dollars. This return, it is agreed, in accordance with the then published rules of the Treasurary Department, the executors of said Estate reported this transaction described above in the sum of nine million nine hundred ninety thousand dollars as ordinary income, deducting from that amount the deficiency in the amount of twenty-seven and a half percent, in the amount of two million two hundred seventy thousand dollars, and they also deducted expenses attributable to the sale in the sum of ten thousand nine hundred ninety dollars, and the net income on the report on account of those transactions, therefore, was seven million two hundred thirty-two thousand thirteen dollars [fol. 176] and seventy five cents. It is agreed thereafter that on February 1, 1952, and within three years from the date of filing of the return they filed a timely claim for refund in the amount of three million six hundred thousand dollars plus. Attached hereto as a part of this stipulation as Exhibit No. 3 is a photostatic copy of the refund claim, a correct copy of the claim, as filed before the Collector. As a result of the claim, an over assessment of eighty nine hundred fifty dollars, plus interest of thirty-five hundred dollars, was refunded on February 2, 1951. And I might say that was wholly unrelated to the issue in this transaction. And by registered mail on March 12, 1953, the Director notified the plaintiffs that the balance of the claim was rejected to the extent not previously allowed. Now, it is further agreed, if the Court please, that if the gains from the transaction were properly taxable as income from the sale as capital assets held for more than six months, then, and not as ordinary income, the basis for computing the gain is one million nine hundred twenty-five thousand five hundred five dollars and five cents; that is on the basis of

capital gains treatment. It is further agreed that under this transaction, and under the instrument of transfer, Exhibit No. 1, that that instrument provides that after the property described had produced to Blackburn the sum of ten million dollars with interest thereon at four percent per annum the property would revert to the grantors; that the aforesaid amount, ten million dollars, taken on a declining rate, with four per cent per annum, received by Blackburn from said properties during a period beginning January 28, 1949, and ending December 24th, 1951, which you will recall is three years, or thirty-six months; upon receipt of the final amount by Blackburn, and in pursuance to the provisions of the transfer to him, he executed a [fol. 177] release in favor of the Estate which said—which release is duly recorded in the Deed Books of Refugio County, and attached is a copy of that release, or transfer, by Blackburn. Now, we also attach as an exhibit to the stipulation Exhibit No. 5, showing the schedule of number of barrels produced from the properties there after the transaction in question, and during the three year period of the so-called payout. This schedule also shows the amount of dollars received by Blackburn in each of the years 1949, 1950 and 1951, and the average price paid per barrel so produced. It is agreed further that at the date of the transaction aforesaid, and in accordance with the information available to the transferrors, the executors, and to Blackburn, and based upon prices then being received for oil, the parties had reason to believe that the properties described in the instrument had a value substantially in excess of the amount paid by Blackburn, and that the properties described in the instrument had a value substantially in excess of the amount paid by Blackburn, and that the properties so described in said instrument would produce over their lives sums substantially in excess of the ten million dollars referred to in the instrument, together with interest thereon at four per cent. Attached is exhibit No. 6, which is a schedule showing the barrels produced for the period 1944 to 1948, inclusive, that is the period preceding the transfer, showing the barrels, the volume, and the amount received from the particular properties which were described in and made the subject of instrument of transfer. The schedule also shows the average price received per barrel from the individual properties. On November 26, 1948,

which is the date of the transfer, it is agreed that, based upon agreements reached with the Government engineers in connection with the settlement of Federal Estate Tax liability of the Estate of Thomas O'Connor, deceased, it [fol. 178] is estimated that on the date of the transfer there were approximately twenty-three million one hundred fifty thousand barrels of oil, of recoverable oil, in place under the properties in question, and that after Blackburn had recovered the ten million dollars and interest, as aforesaid, it was estimated there was approximately nineteen million one hundred fifty thousand barrels of recoverable oil in place under said properties. Now, it is further agreed, as Mr. Mehaffy said, that the amount received by the Estate from Blackburn was not used in the development of oil properties of theirs, or any other oil property, nor were the said sums pledged or ear-marked or agreed to be used in connection with any such oil development. We also attach as an exhibit a photostatic copy of income tax returns filed for the years in question. Now, then, Your Honor, that is our stipulation.

Now, we have two witnesses to supplement this to a slight degree dealing with the nature of these transactions. First I would call Mr. Dennis O'Connor.

Dennis O'Connor, a witness called by the plaintiffs, having been duly sworn testified as follows:

Direct examination.

Questions by Mr. Jackson:

Q. Your name is Dennis O'Connor?

A. Yes, sir.

Q. And you are the son and heir of Tom O'Connor, deceased?

A. Yes.

Q. And you are the independent executor of the estate? [fol. 179] A. Yes.

Q. You act as an independent executor with Katherine O'Connor, your mother?

A. That is right.

Q. Did you negotiate this transaction that we referred to in the stipulation between yourself and Mr. Blackburn?

A. Yes, sir.

Q. Will you tell us your understanding of that transaction, precisely what it was?

A. Well, my understanding was that on the assignment to him of certain royalties that he was to pay me this figure, which was approximately $10,000,000.00, and that when he had recovered $10,000,000.00, plus interest at four percent on the declining balance, this property would revert to the estate, to the heirs.

Q. Was it your understanding that you conveyed to him the estate's entire interest in the described royalties?

M . Mehaffy: Now, Your Honor, I object to that. The instrument speaks for itself, and what Mr. O'Connor's understanding of the meaning of it is would hardly be material.

The Court: I believe I will carry your objection along and not sustain the objection now.

Mr. Jackson: Your Honor, it is well known, of course, that sometimes an instrument on its face may be construed as giving the parties some interest in——

The Court: That is true.

[fol. 180] Mr. Jackson: I would like to have him give his theory whether this was a transfer and not a mortgage.

The Witness: That was my understanding.

By Mr. Jackson:

Q. It was your understanding that you were transferring——

A. I was selling to him a certain amount of oil.

Q. In place?

A. In place.

Q. Now, the provision was that this property would revert to the estate after he had received the specified amount?

A. That is right.

Q. Did your consider this in any way to be a loan or a mortgage?

A. No, sir.

Q. When you made the transfer, or when you executed this instrument, did you have any agreement with Black-

burn of any nature under which you guaranteed to Blackburn, or to anyone else, that this property that was transferred to him would produce the $10,000,000.00 and interest thereon as provided therein?

A. No, I made no agreement or guarantee. He had engineers to see it.

Q. Did you have any agreement with him, or with anyone else, that you would indemnify, or save, either Mr. Blackburn or anyone else in the event the property did not produce the agreed amount?

A. No.

[fol. 181] Q. Did you have any agreement in the nature of an option, or an agreement, to re-purchase in the event the properties would not pay out?

A. No, sir.

Q. Did you execute any notes, or anything of that kind?

A. No. Well, shortly later after that Mr. Blackburn in order to raise the purchase money, dealt with the Chase National Bank in New York.

Q. I would like to ask you did you have anything to do with that whatsoever, with the way of, or the means of, Mr. Blackburn procuring the purchase money in this case?

A. None whatsoever.

Q. Specifically did you deal in any way, or negotiate in any way, with the Chase National Bank in New York?

A. No. I will qualify that by saying I made available to him deed records and things of that sort, to their attorneys.

Q. Now, one further question. If these properties that were transferred, the royalties that were transferred, had not paid the agreed sum, where would that risk have fallen on you or the estate, or on Mr. Blackburn, in your opinion?

A. It would fall on Mr. Blackburn; he bought it.

Q. Now, I would like to ask you, Mr. O'Connor, to tell us the necessity for making this particular transaction; will you tell us the financial condition of the estate at the time, and the purposes of raising the funds, and the reasons for raising it in this way, in your own words?

[fol. 182] A. Well, may I use a memorandum I made up here of the facts and figures. As of the time, the latter part of November, 1948, final Federal estate taxes on the estate of Thomas O'Connor had been determined to be $13,360,000.00, that is round figures. The State inheritance tax

had been calculated to be $3,265,000.00. The estimated income of the estate—the income taxes of the estate for the year, fiscal year, 1948, which was to end in just a few days, exclusive of any oil payment, was estimated to be $2,755,000.00, or a total tax liability of the estate, inheritance and income taxes of $19,376,000.00. Now, prior to the time this oil payment was sold, as executor I had paid the Government $10,755,000.00 of Federal estate taxes, and I had paid the State of Texas $1,105,000.00 in State inheritance taxes, for a total amount of $11,860,000.00. Taxes still due after those payments as of about the date of this sale was $7,516,000.00. The Estate had cash on hand of approximately $3,300,000.00, to leave $7,516,000.00 worth of taxes, or we had a deficiency in cash of some $4,216,000.00. Now, after selling this oil payment——

Q. May I break in for just a moment. You said you had $3,000,000.00 plus of cash on hand?

A. Approximately $3,300,000.00.

Q. Did you have cattle or stock or other liquidated assets on hand?

A. No. I had at that time liquidated all of the assets of the Estate except land and mineral interests attached to it, and of course, cash. I sold the stocks, bonds, cattle, equipment; everything.

Q. So, even after those sales, and liquidation of those assets, your cash deficiency was, as you say, what?

[fol. 183] A. The cash deficiency ws $4,216,000.00.

Q. Now, proceed with the oil payment.

A. Well, I had calculated that, using ordinary income tax rates, which the bureau advised me were applicable at the time, that I would have a net of about $4,380,000.00 proceeds from that sale of the oil payment to apply against this $4,216,000.00 deficieney, which left me some $165,000.00 to clear up things like costs of settling the Estate; attorneys' fees; and accounting; ad valorem taxes and things of that sort.

Q. And the money so raised was actually devoted to these taxes as you have related?

A. It was.

Q. And after the tax liability had been taken care of out of the proceeds derived, you had left—what did you say?

A. I think about $165,000.00.

Q. That was to take care of the administration and other operating costs?

A. Yes, and ad valorem taxes.

Q. Now, Mr. O'Connor, I would like to go back just a moment to the transaction with Mr. Blackburn. I will ask you if in delivering the instrument in question, the transfer that was recorded in the Deed Records of Refugio County, involved in these royalties, did you cause to be attached to said instrument documentary stamps as required by Federal laws?

A. Yes. I have a photostat of my check in the amount of $10,990.00 for documentary stamps.

[fol. 184] Q. That amount was used in the purchase of documentary stamps, and you caused those stamps to be affixed to the instrument in question?

A. Yes.

Q. Now, Mr. O'Connor, I want to pursue one other line of testimony. This relates to the character of the property in question, and to the activities of your father before he died, and to the activities of the executor, on the question of whether you were conducting—of your activities in selling this oil payment and royalty. You said that these royalties, which were the subject matter of this transfer, came to the Estate at the death of your father?

A. That is right.

Q. Now, will you tell us how your father came to obtain those royalties?

A. Well, my father, under the will of his father, his name was Dennis O'Connor, who died in 1900, received a portion of Dennis O'Connor's Estate, which was run together as one unit until January 1st, 1908, at which time the land in question was partitioned to my father, Thomas O'Connor. It was the Cullen Creek Ranch; the name of the property. It was a cattle ranch, and until leased for oil that was the only thing that was done with it.

Q. Do you know about what time your father leased these properties?

A. About 1934.

Q. And in that lease he reserved certain specified royalty interests, is that right?

A. Yes.

[fol. 185] Q. And those same royalty interests passed to the Estate and to the heirs, at his death?

A. That is right.

Q. And that same royalty interest was transferred to Blackburn in the instrument in question with the revertible provision that after Mr. Blackburn had regained the certain $10,000,000.00 plus interest that is in question?

A. That is true.

Q. Now, let me ask you, did you, or did your father, so far as you know, in his lifetime and prior to this death, buy and sell royalties or other mineral interests?

A. No.

Q. So far as you know did he ever buy any royalties of any kind?

A. No.

Q. Then, as far as selling mineral interests—of course, he leased this property?

A. Of course, he leased the property.

Q. But having made a lease on his ranch property, did he at any time sell any royalty?

A. No, he never sold any.

Q. Now, I will ask you whether the Estate, following his death, except for this particular transaction, bought or sold royalties, or other mineral interests?

A. No, they never did.

Q. So far as you know did he ever, during his lifetime, make a transaction of this kind in which he sold, we will [fol. 186] say, an oil payment?

A. No, he didn't.

Q. Did the executors of the Estate, of his Estate, preceeding this transaction, may any comparable oil payment transactions?

A. No, we never made any at all.

Q. In this period of time did the heirs of the Estate buy and/or sell oil payments?

A. As a member of a partnership of an oil firm I participated in the sale of an oil payment prior to the time of this sale.

Q. And that was one oil payment sale that you made through a partnership?

A. That is right.

Q. That partnership was composed of yourself and others?

A. Three others.

Q. Three others. Now, what was the purpose of that sale?

A. That purpose was to raise money to drill oil wells.

Q. And other than that had there been any other oil payment transactions up to the date of the occasion of this sale?

A. No.

Q. Now, I am sorry I didn't ask you this before, but when we got into the question of the purposes to which these funds were to be devoted, may I ask you why it was [fol. 187] that you elected to sell an oil payment to Blackburn rather than borrow the money from a bank?

A. My reason was simply that as executor of the Estate if I could sell an asset and get the cash to pay off the debts and distribute the corpus of the Estate, what was left, I would be discharged from my obligation as executor. I was keenly desirous of having that done. If I had borrowed the money I would have had a debt hanging over that would have taken years——

The Court: Raise your voice, please.

A. As I said, my purpose in selling an oil payment rather than borrowing the money was that I wanted to be through with the thing once and for all. I wanted to sell something and get the money to pay the debts and get released as executor of the Estate after having distributed the remaining assets.

Q. You did not desire to distribute the assets to the heirs along with a very large debt; that it would be necessary to pay the taxes?

A. That is right. It was my understanding that as executor I would have to continue to serve until the debts were paid.

Q. You spoke of this oil payment being made by your partnership for the purpose of getting funds to produce oil and gas; was your father a member of that partnership?

A. No.

Q. Was outside members—were there any members of that partnership who were outside of the family?

A. Yes.

Mr. Jackson: I believe that is all.

[fol. 188] Cross-examination.

Questions by Mr. Mehaffy:

Q. Mr. O'Connor, it is stipulated in this case that we have a schedule showing the amounts in barrels and dollars of production of the property described in this transfer instrument for 1949, 1950 and 1951. Could you tell us from your own knowledge whether or not approximately the same production was had from these same properties for 1952, 1953, '54, and as of the present date?

A. Well, production, of course, has not been as great in later years, because proration has cut down production. The rate of permissive flow is much less than it was at that time.

Q. But there has been no real difference in the productivity of the property as a whole since 1949 and '50, '51?

A. Oh, yes. Naturally as the oil field became depleted salt water enters more and we produce vast quantities of salt water. We have had in the last two or three years to drill salt water disposal wells, and pretty expensive systems to get rid of salt water by putting it back in the ground.

Q. Well, of course, that is true in any producing area at certain times, generally speaking?

A. As the fields become more depleted.

Q. But overall, generally the production has continued up to the present moment?

A. Production has continued. It hasn't been as much and——

Q. Mr. O'Connor, will you tell the Court, Please, sir, [fol. 189] who are the members of the partnership that you referred to, the partnership that made the one sale?

A. I am a member of it; my brother Tom O'Connor is a member of it; Diane Breland is a member; and L. A. Norton is a member of it.

Q. L. A. Norton is the individual who is a member of this partnership and who is not related to the O'Connors; is that right?

A. That is right.

Q. And Mrs. Breland is who; identify her?

A. Mrs. Breland is my sister.

Q. Your sister, and one of Tom O'Connor's heirs?

A. That is correct.

Q. You stated in response to Mr. Jackson's question that in relating the financial status of the Estate, and your position as executor at the time, that you had liquidated assets of the Estate and still had this deficiency in money left?

A. Yes.

Q. Remaining. To whom did you sell those assets; were there a great number of sales, or——

A. Well, there were a great many. We sold municipal bonds and government bonds, of course, on the market. We purchased—the heirs formed a partnership—formed two partnerships, and purchased——

Q. The O'Connor heirs?

A. Yes. Formed a partnership—formed two partnerships and purchased two separate herds of cattle.

[fol. 190] Q. Were outside-s, or individuals not related to your family, members of either of those two partnerships?

A. No.

Q. They were composed of Thomas O'Connor heirs?

A. The ones that bought the cattle, yes.

Q. Now, what else did those partnerships composed of the heirs purchase from the Estate?

A. Well, equipment, ranching equipment; saddles and cattle; horses, and things of that sort; trucks.

Q. Now, did those things to which you have just referred take care of the—substantially the greater part of the liquidation of the assets of the Estate?

A. Yes, the cattle were—well, of course, I think maybe the municipal bonds and the government bonds were bigger than the cattle, as I remember, or about the same.

Q. But the bonds and the cattle and the horses and the equipment, and those sort of things, did together make up a very substantial part of the assets when they were liquidated.

A. I would say roughly half.

Q. Now, just what other assets were there, just briefly, just generally?

A. Well, as I say, there were bonds and stock and, well, of course, cash.

Q. No, to what did your answer of "one half" refer; cattle and equipment?

A. Yes, the cattle and ranching equipment I would say represented probably half.

[fol. 191] Q. And then another substantial portion of the assets consisted of municipal bonds and other government bonds and stocks and things of that sort?

A. That is correct.

Mr. Mehaffy: Will you indulge me just a moment, your Honor. That is all, thank you.

Re-direct examination.

Questions by Mr. Jackson:

Q. Just a moment. This partnership that bought the cattle was composed of the heirs of the Estate, is that right?

A. That is correct.

Q. The same people who were heirs of the Estate?

A. That is correct.

Q. I asked you did they purchase from you as the executor of the Estate these assets at their fair market value?

A. Well, the cattle at the time we purchased them, which was sometime after the death of my father, had enhanced in value some so that the Estate sold the cattle to this partnership at somewhat a higher value than had been agreed with the Federal revenue people as their value, because of the price of cattle going up. And this involved a lot of steers who had grown up from maybe one year old to two or three years old. And the Estate realized that capital gain from the sale of the breeding herd, because the price it received was somewhat larger than the cost they had in them.

Q. The individual members of this partnership with their own resources and their own funds, purchased these, shall [fol. 192] we say, frozen assets from you as executor of the Estate with their own funds?

A. That is correct.

Mr. Jackson: I believe that is all, your Honor.

Mr. Mehaffy: That is all, your Honor.

Mr. Jackson: Thank you, Mr. O'Connor. I would like to call Mr. Dave Blackburn.

Mr. Mehaffy: I understood Your Honor to say that my objection was carried through, carried forward through all of Mr. O'Connor's testimony?

The Court: I finally said it was overruled after finding out his purpose, counsel, after finding out his purpose, which he stated was for the purpose of showing the faith of the transaction, but not for the cause of the sale.

Mr. Mahaffy: And my objection as to his interpretation is overruled?

The Court: It is overruled.

Mr. Mehaffy: The written instrument itself is——

The Court: For the purpose of the sale; which he testified.

Mr. Mehaffy: Well, he finally said, "Yes, it was a sale and in no sense a mortgage."

The Court: That is right, and you objected to that.

Mr. Mehaffy: Yes, sir.

The Court: And I overruled that objection.

(Thereupon the witness stood aside.)

[fol. 193] D. E. Blackburn, a witness called by the plaintiff, being duly sworn, testified as follows:

Direct examination.

Questions by Mr. Jackson:

Q. Your name is D. E. Blackburn?

A. Yes, sir.

Q. Mr. Blackburn, were you a participant in the transaction with Mr. Dennis O'Connor, which transaction has been referred to in the stipulation which was filed with the Court?

A. Yes, sir.

Q. Will you tell us your understanding of what that transaction was?

A. Well, my understanding was that, that we had there, I bought a $10,000,000.00 oil payment from him.

Q. That you bought a $10,000,000.00 oil payment; you were not lending him the money?

A. No, sir.

Q. Now, did you have any other agreement with him relating to that transaction, such as an agreement that he would indemnify you, or save you harmless, from any loss in case the oil payment did not pay out?

A. No, sir.

Q. Did he guarantee that oil payment in any way?

A. No, sir.

Q. Did he have any agreement with you, relating to your rights to resell it to him?

A. No, sir.

Q. In the event it did not pay out?

A. No, sir.

[fol. 194] Q. Now, where did you get the money with which to pay him this $9,900,000.00?

A. I borrowed that money from the Chase National Bank in New York.

Q. And you borrowed that money yourself?

A. Yes, sir.

Q. Did you give to the bank your own personal note?

A. Yes, sir.

Q. Was that a negotiable note?

A. Yes, sir.

Q. What was the term of that note?

A. It was a thirty-six month note payable out of the oil returns on that oil payment.

Q. What was the interest rate on that note?

A. Four per cent.

Q. Was that note secured in any way?

A. Secured by a Deed of Trust on the oil payment.

Q. The oil payment bore interest at four per cent—did you say that the interest rate on the note that you gave to the Chase National Bank was four or three and a half per cent, the interest rate on the note to the Chase National Bank?

A. It was three and a half per cent that I paid the Chase National Bank, and the oil payment was four per cent; four per cent on the payment.

Q. Are you related in any way to the O'Connors by blood or by marriage?

A. No, sir.

Q. What is your profession or business capacity?

A. I am a banker.

[fol. 195] Q. Banker?

A. Yes, sir.

Q. And what was your official capacity or position at the time of this particular transaction?

A. I was president of the Victoria Bank and Trust Company.

Q. And you are a stockholder in that bank?

A. Yes, sir.

Q. You are not an employee of any of the O'Connors?

A. No, sir.

Q. And you were not at the time this transaction was made?

A. No, sir.

Q. Now, when this transaction was made did you make that individually and in your own right, or as an official of the bank?

A. I made it in my own right.

Q. Did you make a profit on this particular transaction?

A. Yes, sir.

Q. Approximately how much profit did you make on the transaction?

A. A gross profit of approximately $110,000.00.

Q. Did you report that profit to the Government for income tax purposes, to pay income taxes thereon?

A. Yes, sir.

Q. You did that personally?

A. Yes, sir.

Q. Did the bank have any interest whatsoever in that transaction?

[fol. 196] A. None at all.

Q. Are, or were, the O'Connors, at this time to your knowledge, stockholders in the Victoria Bank and Trust Company?

A. They were.

Q. All right. Take the family collectively; what total percentage of stock would you say the O'Connors owned at that time?

A. They owned approximately twelve per cent.

Q. And the remaining percentage was held by others?

A. By various stockholders.

Mr. Jackson: I believe that is all, Mr. Mehaffy. Your witness.

Cross-examination.

Questions by Mr. Mehaffy:

Q. Mr. Blackburn, you stated, I believe, that you had no side agreements or guarantees or anything of that sort with Mr. O'Connor, or with the O'Connor Estate, which would protect you or guarantee that you would receive this $10,000,000.00 plus interest?

A. That is right.

Q. The only assurance that you had was the properties involved in oil payment?

A. That is right.

Q. The production of oil from those properties.

A. Yes, sir.

Q. And the only security you gave to the Chase National Bank was a deed of trust on that payment, which you got by reason of this assignment?

A. Yes, sir.

[fol. 197] Q. And you entered into that transaction necessitation your borrowing $10,000,000.00 from the Chase National Bank, agreeing to pay interest at the rate of three and a half per cent, with the expectation of making a profit of the amount that you mentioned, which was $110,000.00?

A. Yes, sir.

Q. And what was your expectation with regard to your financial security in the transaction; did you have any evidence or information availiable which assured you that you would receive this sum of money?

A. Yes, sir. I had the oil payment on those oil royalties from the Tom O'Connor Estate, I owned them.

Q. What information did you and Chase National Bank have with respect to the value of this oil payment?

A. I was personally more or less familiar and knew something about these oil royalties, and then we had engineers' reports on it on the values there, and we also had the Government's report on the value in the settlement of the Estate, the taxes. So we more or less knew the values

at the time we purchased it, and, of coure, the Chase National Bank naturally had their own engineers to come down and put a value on it.

Q. That information, of course, was available, or made available to both you and Chase National Bank before either of you would enter into such an agreement?

A. No, sir. That was made available to us before the transaction was finally consummated, but I bought the payment from them at the time. I had a commitment from the Chase National Bank for the loan subject to the approval of their engineers.

Q. Subject——

[fol. 198] A. And the title proved up.

Q. Subject to approval of the collateral?

A. That is right.

Mr. Mehaffy: Excuse me one moment. That is all, Your Honor.

Mr. Jackson: The Plaintiff rests, Your Honor. That is all.

Mr. Mehaffy: That is all for the Defendants, Your Honor.

The Court: All right, gentlemen. The Court will take this matter under advisement. Mr. Jackson, how long would it take you to get up a brief and a written argument?

Mr. Jackson: A week or ten days, Your Honor.

The Court: You can get one up in that time?

Mr. Jackson: Yes.

The Court: I will give you two weeks. What about you, Counsel?

Mr. Mehaffy: Your Honor, may I make a little statement? Mr. Jackson has been most cooperative, and we have, subject to his commitments and mine there, in and out of town, have done the best we could to expedite this matter. I would like to be given ample time to prepare a brief after receipt of Mr. Jackson's brief, with the understanding that I will represent to the Court that it will be forthcoming at the earliest possible moment. In other words, if I have no trips at that particular time out of the office I will get the brief out immediately.

The Court: Well, how much time do you think it would take after you get Mr. Jackson's brief?

[fol. 199] Mr. Mehaffy: I think three weeks would be ample.

The Court: I will give you thirty days.

Mr. Mehaffy: Thirty days? I will make every attempt to do it.

Mr. Jackson: Is that thirty days after receipt of my brief?

The Court: Yes. And you may have ten days after your receipt of his brief in which to reply.

Mr. Jackson: Thank you, Your Honor.

The Court: Anything further?

Mr. Jackson: I believe that is all.

Mr. Mehaffy: No, that is all.

Mr. Jackson: Thank you very much.

The Court: The court will recess.

Thereupon at 10:25 A.M., Friday, November 4, 1955, the trial of this case was closed in the San Antonio Division of said Court.

[fol. 200] Reporter's certificate of foregoing transcript ommitted in printing.

[fol. 201] In United States District Court

Memorandum Opinion—February 20, 1956

The Court, having considered the evidence adduced upon the trial of this cause and the briefs of the parties, finds that the plaintiffs are entitled to judgment herein.

The Clerk will notify the attorneys of record in this cause of the opinion of the court, and request plaintiffs to prepare and submit to the court tentative findings of fact and conclusions of law, and judgment, and furnish copies thereof to the attorneys for the defendant.

(Signed) Ben H. Rice, Jr., United States District Judge.

[fol. 202] IN UNITED STATES DISTRICT COURT

JUDGMENT—March 27, 1956

The above-entitled action was heard on November 4, 1955. Came the plaintiffs by and through their attorneys, and came the defendant by and through the United States Attorney for the Western District of Texas. Each announced ready for trial. The Court heard the pleadings and has considered the evidence and arguments of counsel. The Court is of the opinion that plaintiffs are entitled to judgment of defendant in the amount of $3,607,153.59, plus allowable interest and court costs.

It is therefore ordered, adjudged and decreed that plaintiffs, Dennis M. O'Connor and Katherine O'Connor, Independent Executors of the Estate of Thomas O'Connor, Deceased, and Dennis M. O'Connor, and Katherine O'Connor, Mary O'Connor Braman, joined herein by her husband, D. H. Braman, and Thomas O'Connor, Jr., do have and recover of and from the defendant, judgment in the amount of $3,607,153.59 with allowable interest and court costs.

Dated at Waco, Texas, this the 27th day of March, 1956.

(Signed) Ben H. Rice, Jr. Judge, United States District Court Western District of Texas.

[fol. 203] IN UNITED STATES DISTRICT COURT

CERTIFICATE OF PROBABLE CAUSE—Filed: March 27, 1956

The Court hereby certifies that there was probable and reasonable cause for the act of the defendant, the Collector of Internal Revenue, in demanding and collecting from the plaintiffs the internal revenue tax, for the refund of which Judgment was entered in the above-entitled action on the 27th day of March, 1956.

Dated at Waco, Texas, this 27th day of March, 1956.

(Signed) Ben H. Rice, Jr. Judge, United States District Court, Western District of Texas.

[fol. 204] In United States District Court

Findings of Fact and Conclusions of Law—Filed March 27, 1956

This case arises under the provisions of the Internal Revenue Code of 1939. It involves income taxes together with interest paid by the Estate of Thomas O'Connor, Deceased, for the taxable year ended November 30, 1948.

The above-entitled action was tried without jury by the Court in San Antonio, Texas, on November 4, 1955.

The question involved in the case is as follows:

Were the plaintiffs taxable at long term capital gain rates or at ordinary income rates on the gain realized from the sale of an oil payment during the fiscal year ended November 30, 1948, to D. E. Blackburn?

The Court having considered the oral testimony, stipulated facts and the briefs of counsel and being fully advised otherwise in the premises, makes and enters the following findings of fact and conclusions of law.

Findings of Fact

1. Thomas O'Connor died testate in Victoria County, Texas, on December 5, 1946. Plaintiffs Dennis M. O'Connor and Katherine O'Connor, duly qualified as Independent Executors of the Estate of Thomas O'Connor, Deceased, and are now acting in such capacity. Plaintiffs Dennis M. O'Connor, Katherine O'Connor, Mary O'Connor Braman and Thomas O'Connor, Jr. are the sole heirs at law and devisees under the will of Thomas O'Connor, deceased. D. H. Braman is the husband of Mary O'Connor Braman. [fol. 205] 2. In the fiscal year of the Estate ended November 30, 1948, to-wit, on November 26, 1948, the Executors of the Estate transferred, by general war-anty deed, certain royalty interests (subject to a reversionary interest, as hereinafter stated) to D. E. Blackburn of Victoria, Texas, for the cash consideration of $9,990,350.00. The deed making such transfer was delivered to D. E. Blackburn and duly recorded in the Deed Records of Refugio County, Texas, with some $10,000.00 in documentary stamps having been attached to the deed. Expenses attributable to the sale amounted to $10,990.00. The royalty interests sold to

Blackburn had been held by decedent and subsequently by his Estate for many years. The properties sold to Blackburn had been held by plaintiffs in excess of six months.

3. If the gain from the transaction in question is properly taxable as income on the sale of a capital asset held for more than six months, and not as ordinary income, the basis for computing such gain is $1,925,105.81.

4. The above mentioned transaction was consummated on November 26, 1948 and was carried out in accordance with its terms. Blackburn, as owner of the royalty interest, received the money from the companies running the oil from the properties, pursuant to transfer orders executed by plaintiffs to the respective pipe line companies.

5. The deed above referred to provided that after the royalties described therein had produced sufficient oil to pay the purchaser, D. E. Blackburn, the sum of $10,000,000.00 (with interest as computed thereon at the rate of 4% per annum), the properties would revert to the grantors. The aforesaid amount was duly received by Blackburn from said properties during the period beginning January 28, 1949 and ending December 24, 1951. Upon [fol. 206] receipt of this amount, Blackburn, the purchaser, pursuant to the provisions in the deed, executed his quitclaim deed, reconveying the royalties to the Estate, which quitclaim was duly recorded in the Deed Records of Refugio County, Texas.

6. Both the sellers and the buyer (D. E. Blackburn) intended the transaction in question to be a sale and purchase of the royalty interests in question. They did not intend to enter into a loan or a mortgage transaction. At no time did the Executors, individually, or in their fiduciary capacity, make any guaranty or agreement to indemnify the purchaser or enter into agreements with the purchaser other than the agreement to sell, as set forth in the deed. At all times, the risks incident to the presence and production of sufficient quantities of oil to make the transaction profitable for the purchaser were upon the purchaser. The purchaser, D. E. Blackburn, borrowed the purchase money from Chase National Bank of New York, giving his note and a deed of trust on the properties purchased by him. The bank dealt only with Blackburn and looked only to him. The plaintiffs did not have anything to do with Blackburn's

bank loan. The transaction in question was real and bona fide and was, in no sense, a sham or a subterfuge. Blackburn made a substantial profit on the transaction and reported and paid tax on his profit.

7. The purpose of the sale of the oil payment was a bona fide business purpose, to-wit, to raise money to pay federal estate taxes and state inheritance taxes due by reason of the death of Thomas O'Connor, deceased, and to pay administration expenses of the Estate. The Estate was in need of cash resources with which to pay these charges and for these reasons the oil payment was sold.

[fol. 207] 8. The sale in question was the first and only sale of oil payments or other mineral interests that the Estate had made until that time. Neither the decedent, Thomas O'Connor, nor his Estate, was in the business of selling oil payments or other mineral interests. The limited royalty interests, the oil payment in question, was not held primarily for sale to customers.

9. The oil payment "paid out" after three years of production, during which the properties were owned by Blackburn. The oil payment would have taken an appreciably longer period to pay out had it not been for the fact that there was an increase in the production in the field by the operating lessees and had it not been for the further fact that there had been a substantial increase in the price of oil shortly prior to the sale of the oil payment, which higher price was maintained during the period of the pay-out.

10. The royalty interest (or oil payment) sold to Blackburn represented a substantial part of the plaintiffs' oil in place. Also, in terms of the relative values of the interest sold and of the reversionary interest retained by the sellers, the transfer represented a substantial part of the sellers' royalty interest.

11. The Executors of the Estate of Thomas O'Connor, Deceased, filed a fiduciary income tax return for the fiscal period ended November 30, 1948, reporting the gain on the sale as ordinary income. This gain was reported as ordinary income because of the ruling of the Commissioner of Internal Revenue, published in 1948, requiring such gain to be so reported. Thereafter, a timely claim for refund was filed, which was rejected (except as to a minor item not here involved), notification of such rejection being received in a registered letter dated March 12, 1953, and sub-

[fol. 208] sequently, this suit was brought within the time prescribed by the Internal Revenue Code.

12. There was probable and reasonable cause for the acts done by Frank Scofield, the former Collector of Internal Revenue, acting pursuant to the orders and directions of the Commissioner of Internal Revenue.

Conclusions of Law

1. This Court has jurisdiction of the subject-matter of and the parties to this case.

2. The transaction with D. E. Blackburn was a bona fide sale.

3. The sale to Blackburn was a sale of a royalty interest in producing oil properties in Texas, subject to a reversion to plaintiffs after the royalties had produced in Blackburn's hands the prescribed amount. This was a sale of what is commonly called an oil payment. This oil payment was a real property interest under the law of Texas, and, under the tax laws, a property interest in oil in place. The transaction was not intended to be and was not, as a matter of fact or a matter of law, an assignment of income, but was the sale of a property interest to Blackburn, which property interest produced income in the hands of Blackburn. This property interest was substantial and real, representing a substantial part of the grantors' royalty interest. The property so sold was a long-lived, and not a short-lived, oil payment.

4. The property interest so sold to Blackburn was a capital asset as defined in Section 117 of the Internal Revenue Code of 1939, and this capital asset had been held by plaintiffs for more than six months.

[fol. 209] 5. None of the exceptions in Section 117 or elsewhere in the Internal Revenue Code, denying a transaction long term capital gain treatment, are applicable to the instant transaction.

6. Plaintiffs are entitled to receive long term capital gain treatment under Section 117 on the sale of the oil payment in question to Blackburn.

7. Judgment shall be entered for the plaintiffs. By reason of the probable cause for the acts of the Commissioner or other officials of the Treasury Department, as found by the Court, the judgment, on becoming final, shall be pro-

vided for and paid out of the propert appropriations from the Treasury of the United States.

(Signed) Ben H. Rice, Jr., United States District Judge.

March 27, 1956.

[fol. 210] In United States District Court

Notice of Appeal in the Court of Appeals Under Rule 73(b)—Filed April 18, 1956

Notice is hereby given that Frank Scofield, Former Collector of Internal Revenue, defendant above named, hereby appeals to the United States Court of Appeals for the Fifth Circuit from the memorandum opinion entered on February 20, 1956, and from the final judgment entered on March 28, 1956.

(Signed) Russell B. Wine, United States Attorney for the Western District of Texas, P. O. Box 1701, San Antonio, Texas.

Certificate of Service (omitted in printing)

[fol. 211] In United States District Court

Designation of Contents of Record on Appeal—Filed April 28, 1956

Pursuant to Rule 75(a) of the Federal Rules of Civil Procedure, the defendant-appellant hereby designates the following portions of the record, proceedings and evidence to be contained in the record on his appeal from the final judgment herein:

1. The entire record of the above proceedings, including all docket entries.

(Signed) Russell B. Wine, United States Attorney, 347 Federal Building, San Antonio, Texas, Attorney for defendant-appellant.

[fol. 212] In United States District Court

List of Docket Entries

[Title omitted]

Basis of Action: Income Tax Case. $3,613,173.03

Mar. 4, 1955. Complaint filed.

Mar. 4, 1955. Summons & 3 Copies (with copy of Complaint attached) issued.

Mar. 16, 1955. Summons Ret. & filed. Ex. 3-4-55 by deliv. copy to Frank Scofield in person & on 3-14-55 by Deliv. Copy to Russell Wine, U. S. Atty., and mailing copy to Atty. Gen. at Washington, D. C. (Trautwein $4.40; Bain, $6.40).

May 4, 1955. Order extending time for filing Answer filed & Ent'd.

May 11, 1955. Answer filed.

Feb. 20, 1956. Memorandum Opinion filed.

Mar. 27, 1956. Findings of Fact and conclusions of Law filed.

Mar. 27, 1956. Judgment ($3,607,153.59 with interest & [fol. 213] costs in favor of Pltffs.) filed & Ent'd.

Mar. 27, 1956. Certificate of Probable Cause filed.

April 18, 1956. Notice of Appeal In the Court of Appeals under Rule 73(b) filed.

Apr. 28, 1956. Designation of Contents of Record on Appeal filed.

May 14, 1956. Court Reporter's Q. and A. Transcript.

[fol. 214] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 215] Minute Entry of Argument and Submission—December 3, 1956, omitted in printing

[fol. 216] IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 16253

FRANK SCOFIELD, Former Collector of Internal Revenue, Appellant,

versus

DENNIS M. O'CONNOR and KATHERINE O'CONNOR, Independent Executors of the Estate of Thomas O'Connor, Deceased, and Dennis M. O'Connor, Kath-rine O'Connor, Mary O'Connor Braman, Joined by Her Husband, D. H. Braman, and Thomas O'Connor, Jr., Appellees

Appeal from the United States District Court for the Western District of Texas

OPINION—February 1, 1957

Before Hutcheson, Chief Judge, and Holmes and Borah, Circuit Judges

HUTCHESON, Chief Judge:

One of several appeals [1] from judgments entered in favor [fol. 217] of taxpayers, after Caldwell's case [2] and before Hawn's case [3] had been decided here, this appeal presents the single question whether, in the light of those cases, a transaction involving oil payments carved out of royalty interests was, as claimed by the taxpayer and found by the trial court, a sale of a capital asset, or was, as claimed by the commissioner, an anticipatory assignment of income.

Making no attack upon Caldwell, in fact conceding in oral argument that it was correctly decided, appellant's whole effort is directed to bringing us into agreement with

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[1] Fleming v. Commissioner, 24 T.C. 818; Wrather v. Commissioner, T.C. ; Weed v. Commissioner, 24 T.C. 1025; Lake v. Commissioner, 24 T.C. 1016.

[2] Commissioner v. Caldwell, 218 F(2) 567.

[3] Commissioner v. Hawn, 231 F(2) 341.

his contentions: That in Hawn's case this court *held* that, though Congress had provided no standard or guide, this and other courts, by the use of a kind of slide rule method not clearly if at all revealed in the decision, could, in their uncontrolled discretion, determine as a fact in each case whether a sale of an oil payment interest is or is not too insubstantial to qualify for capital gains treatment under Section 117; and that, in the exercise of this fact finding power, we should hold as a fact that, because of the insubstantiality of the transaction, the sale made here was not a sale.

It is taxpayer's position: that this court did not in Hawn's case in anywise qualify or limit Caldwell; that it particularly did not hold that, without a legislative standard to guide its decision, it had the power to determine in each case, as a fact, whether an assignment would or would not be regarded as insubstantial; and, finally, that Hawn's case was decided not on the ground of the factual insubstantiality as such of the property purportedly [fol. 218] sold, but on the ground that the facts as a whole did not in law show a sale of property at all but only a loan arrangement.

In support of its view that the court did not intend to lay down any slide rule method of factually determining in each case the insubstantiality of a transfer, but that the case was determined on the ground that, upon its whole facts, what took the form of, was not in fact and in law, a sale, the taxpayer points to the decisive holding of the court:

> "* * * The agreements showed that the parties contemplated using the oil payments over the next two years for the construction of a house for Hawn. * * * The effect was the same as though Hawn had borrowed the funds required, using the oil payments as collateral, and applied the proceeds of such loans to pay the contractor, and then repaid his loans as the oil payments were received. * * * *"

So pointing, he urges upon us that since, as was held in that case, there was no sale but only a loan transaction, the court did not, as the commissioner urges it did, establish, or even undertake to establish, a slide rule for

determining insubstantiality as to a bona fide sale which, upon the stipulated facts and the findings of the trial court, the sale in question here was.

It is true that this court, thus properly deprecating the absence of legislative guide or standard:

> [fol. 219] "Although it might be better if congress[4] provided the answer, in the absence of a congressional determination, it devolves on the court to supply it."

did state that, along with other facts going to the legal effect of the transaction as a whole, the court should determine "whether such transfer is for a substantial interest in the total property owned by the transferor".

It is equally true, however, that it did not undertake to decide the Hawn case on, or in it lay down, any quantitative rule or other guide, fractional or otherwise, for the factual determination by the court in that or any other case as to what would or would not be substantial. Neither did it undertake to hold that if, instead of a fictional or pretended sale, as the court found that the purported sale was, there had been a real sale of an oil payment of $115,000, the court would have been authorized to hold or would have held, that it was insubstantial in amount and, because and only because thereof, it was not a sale.

To the contrary, stating:

> "It is clearly true, as already indicated, that an oil payment like royalty is an interest in property, an interest in realty, and an interest in minerals in place."

and declaring:

> "Deciding, as we do, that not every transfer of oil payments, even for a valuable consideration, [fol. 220] amounts to a sale of capital assets under Sec.

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[4] The Mills Bill, H.R. 9559, dealing prospectively with oil payment sales and related transactions, introduced in the last congress but not passed, illustrates the desirability of legislation to bring about certainty and clarity in this important area of the tax law.

> 117, it becomes necessary for us to determine whether, under the established principles, this transaction was or was not such a sale."

the court went on to say:

> "Upon careful review of the cases and equally careful consideration of the circumstances of this particular transaction, we conclude that this was not such a sale but was rather an assignment of anticipatory income which remained taxable to the respondent."

This is to say, that the court, correctly concluding, on the whole facts, not that there was a bona fide sale which, because in amount it was insubstantial, did not come within Section 117, but that this was not a sale at all, it was a credit arrangement, which, though in form an assignment of the oil interest it purported to deal with, was in fact and in law nothing but an anticipatory assignment of income made as security for, and in payment of, Hawn's debt to the contractor, as correctly *held* that the course of dealings did not amount to a sale or exchange of capital assets under Section 117.

We, therefore, agree with the taxpayer that if, as commissioner contends, this court in the Hawn case did, and we should, without a legislative standard or guide, determine as matter of fact whether and where a time limit was to be drawn upon whether a sale of oil payments was substantial or insubstantial enough to constitute a sale entitling taxpayer to capital gains treatment, the result would be not deciding but mere fiating, or, at best, unwarranted judicial legislation.

[fol. 221] If, however, on the other hand, as the Hawn case held and we hold, the court in each case takes all of the facts into consideration for the purpose of determining whether, as matter of law, a transaction was or was not a sale of capital assets, so as to entitle it to capital gains tax treatment under Sec. 117, the court would only be following and applying the rule laid down in the cases, that not every sale of capital assets, but only those which in law come under the statute, will support capital gains treat-

ment,[5] and that it would be running a good principle into the ground if a taxpayer would be allowed to claim as a sale of capital assets the daily use of small portions thereof in connection with his business and the payment of his day to day expenses.[6]

That the transaction in this case was not of an insubstantial kind is shown, by the fact that it involved a cash [fol. 222] sale for $9,990,350 of an oil payment conveying 4,000,000 barrels of oil in place, and by the undisputed facts and the oral testimony of two witnesses, the government's brief stating, "The oral testimony in uncontradicted and accordingly there are no disputed facts".

It is further shown by the definite and precise findings of the district court which, after setting out the full transaction, categorically and specifically found that the

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[5] Rudco Oil & Gas Co. v. United States, 82 Fed. Supp. 746, "a case", as we pointed out in Caldwell v. Campbell, 218 F(2) 570, "of a corporation dealing deviously through its stockholders * * *". * * * "It was in effect a mere appointment of the stockholders to receive the mineral income of the corporation for sixty or ninety days of the taxable year in which the purported transfer was made. It was, therefore, a completely abortive attempt, like those dealt with in the Horst, the Harrison, and the Eubank cases, to change the statutory rule for the taxation of income by appointing one to collect as his own the income of another."

[6] Cf. what is said by the Supreme Court in Burnet v. Harmel, 287 U.S. 103, arguendo and by decision, and in Corn Products Co. v. Commissioner, 350 U.S. at page 52:

> "* * * Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss.' The preferential treatment provided by Sec. 117 applies to transactions in property which are not the normal source of business income. It was intended 'to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.' Burnet v. Harmel, 287 U.S. at 106."

transaction was a bona fide and effective sale.[7] Based [fol. 223] upon these findings of fact, he concluded as matter of law:

> "The transaction with D. E. Blackburn was a bona fide sale.
>
> "The sale to Blackburn was a sale of a royalty interest in producing oil properties in Texas, subject to a revision to plaintiffs after the royalties had produced in Blackburn's hands the prescribed amount. This was a sale of what is commonly called an oil payment. This oil payment was a real property interest under the law of Texas, and, under the tax laws, a property interest in oil in place. The transaction was not intended to be and was not, as a matter of fact or a matter of law, an assignment of income, but was the

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[7] "Both the sellers and the buyer (D. E. Blackburn) intended the transaction in question to be a sale and purchase of the royalty interests in question. They did not intend to enter into a loan or a mortgage transaction. At no time did the Executors, individually or in their fiduciary capacity, make any guaranty or agreement to indemnify the purchaser or enter into agreements with the purchaser other than the agreement to sell, as set forth in the deed. At all times, the risks incident to the presence and production of sufficient quantities of oil to make the transaction profitable for the purchaser were upon the purchaser. The purchaser, D. E. Blackburn, borrowed the purchase money from Chase National Bank of New York, giving his note and deed of trust on the properties purchased by him. The bank dealt only with Blackburn and looked only to him. The plaintiffs did not have anything to do with Blackburn's bank loan. The transaction in question was real and bona fide and was, in no sense, a sham or a subterfuge. Blackburn made a substantial profit on the transaction and reported and paid tax on his profit.

"The purpose of the sale of the oil payment was a bona fide business purpose, to-wit, to raise money to pay federal estate taxes and state inheritance taxes due by reason of the death of Thomas O'Connor, deceased, and to pay administration expenses of the Estate. The Estate was in

sale of a property interest to Blackburn, which property interest produced income in the hands of Blackburn. This property interest was substantial and real, representing a substantial part of the grantors' royalty interest. The property so sold was a long-lived, and not a short-lived, oil payment.

"The property interest so sold to Blackburn was a capital asset as defined in Sec. 117 of the Internal Revenue Code of 1939, and this capital asset had been [fol. 224] held by plaintiffs for more than six months."

It will serve no useful purpose for us to set out here the undisputed facts on which the findings and conclusions were based. It will be sufficient to say that, on the record made, the district judge was right and his judgment should be Affirmed.

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need of cash resources with which to pay these charges and for these reasons the oil payment was sold.

"The sale in question was the first and only sale of oil payments or other mineral interests that the Estate had made until that time. Neither the decedent, Thomas O'Connor, nor his Estate, was in the business of selling oil payments or other mineral interest. The limited royalty interests, the oil payment in question, was not held primarily for sale to customers.

"The oil payment 'paid out' after three years of production, during which the properties were owned by Blackburn. The oil payment would have taken an appreciably longer period to pay out had it not been for the fact that there was an increase in the production in the field by the operating lessees and had it not been for the further fact that there had been a substantial increase in the price of oil shortly prior to the sale of the oil payment, which higher price was maintained during the period of the pay-out.

"The royalty interest (or oil payment) sold to Blackburn represented a substantial part of the plaintiffs' oil in place. Also, in terms of the relative values of the interest sold and of the revisionary interest retained by the sellers, the transfer represented a substantial part of the sellers' royalty interest."

[fol. 225] IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 16253

FRANK SCOFIELD, FORMER COLLECTOR OF INTERNAL REVENUE,

versus

DENNIS M. O'CONNOR AND KATHERINE O'CONNOR, Independent Executors of the Estate of Thomas O'Connor, Deceased, and Dennis M. O'Connor, Katherine O'Connor, Mary O'Connor Braman, Joined by her Husband, D. H. Braman, and Thomas O'Connor, Jr.

JUDGMENT—February 1, 1957.

This cause came on to be heard on the transcript of the record from the United States District Court for the Western District of Texas, and was argued by counsel:

On consideration whereof, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

[fol. 226] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 227] [Caption omitted]

[fol. 228] Docket No. 46713

IN THE TAX COURT OF THE UNITED STATES

WM. FLEMING AND BESSIE M. FLEMING (husband and wife), Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

PETITION—Filed Feb. 2, 1953

The above-named petitioners hereby petition for a redetermination of the deficiency set forth by the Commissioner

of Internal Revenue in his notice of deficiency (Bureau [fol. 229] symbols Dallas—IRA:90D-D) dated November 10, 1952, and as a basis of their proceeding allege as follows:

1

The petitioners are individuals. They are now, and were at all pertinent times hereinafter referred to, husband and wife. They reside in Fort Worth, Texas, and their office is at 1218 Fair Building, Fort Worth, Texas. The return for the period here involved was filed with the Collector of Internal Revenue for the Second Collection District of Texas, at Dallas, Texas.

2

The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioners on November 10, 1952.

3

The deficiency as determined by the Commissioner is in income taxes for the calendar year 1948, in the amount of $94,113.30, substantially all of which is in dispute.

4

The determination of tax set forth in said notice of deficiency is based upon the following errors:

(a) The respondent erroneously failed to determine that petitioners' gain from the exchange of certain limited overriding royalty interests in oil and gas leasehold for an undivided interest (in fee simple) in ranch lands was [fol. 230] within the purview of Section 112(b)(1) of the Internal Revenue Code, so that said gain was not to be recognized in determining petitioners' taxable income for 1948.

(b) The respondent erroneously failed to determine that the gain derived by a partnership (Fleming Oil Company) of which petitioner Wm. Fleming was a member, from the exchange of certain limited overriding royalty interests in oil and gas leaseholds, for an undivided interest (in fee simple) in ranch lands, came within the purview of Section 112(b)(1) of the Internal Revenue Code, so that said gain was not to be recognized in determining

the net income of said partnership for the calendar year 1948 and in determining petitioners' distributive share of said partnership income.

(c) Alternatively, the respondent erred in failing to determine that the gain from the exchanges referred to in subparagraphs (a) and (b) above was taxable as long-term capital gain, rather than as ordinary income subject to depletion.

5

The facts upon which the petitioners rely as the basis of this proceeding are as follows:

(a) Throughout the applicable periods herein referred to, petitioners were husband and wife, residing together in Fort Worth, Texas. They kept their books and records upon the cash receipt and disbursement basis and for [fol. 231] calendar-year periods. They duly filed a joint income tax return for the calendar year 1948 upon the cash receipt and disbursement basis.

(b) Throughout the year 1948, as well as prior and subsequent thereto, there existed a partnership known as Fleming Oil Company, which had its office and principal place of business at 1218 Fair Building, Fort Worth, Texas. This partnership was primarily engaged in the business of acquiring, developing and operating oil and gas properties, but from time to time made other investments. This partnership kept its books and records upon the cash receipt and disbursement basis and accounted for calendar-year periods, and it duly filed income tax returns on such basis and for such periods.

(c) Prior to 1948, the partnership of Fleming Oil Company was composed of Wm. Fleming, a petitioner herein, in his individual capacity; Wm. Fleming Trustee, a private trust of which the said Wm. Fleming was the sole trustee and of which Mary D. Fleming Walsh, his daughter, was the beneficiary; and the Estate of Anna Maud Fleming, deceased. The said Wm. Fleming was the surviving husband of the said Anna Maud Fleming (who died in 1941 a resident of Fort Worth, Texas) and was the duly appointed, qualified and acting Independent Executor of the estate and will of said Anna Maud Fleming. The interest of the said Wm. Fleming individually in said partnership was 30.513%; the interest of said estate was 30.513%; and

the interest of the trust Wm. Fleming Trustee in said partnership was 38.974%. The respondent has heretofore determined that the administration of the estate of Anna Maud Fleming, deceased, should be considered as [fol. 232] closed for income tax purposes as of December, 31, 1947, and that thereafter Wm. Fleming Individually should report the share of the income of the partnership Fleming Oil Company which was reportable in tax returns filed on behalf of said estate for 1947 and prior years. The deficiency determination here involved, in so far as it relates to the income of Fleming Oil Company for the calendar year 1948, was determined in accordance with the foregoing, that is, there was included in the income of these petitioners for the calendar year 1948, 61.026% of what the respondent determined to be the net income of said partnership Fleming Oil Company for the calendar year 1948.

(d) On May 19, 1948, the said partnership Fleming Oil Company owned ordinary commercial oil and gas leases, or interests therein, on lands located in Texas. These leaseholds were known as the Denman "C" Lease, the Denman "H" Lease, the Reid "A" and "B" Leases, and the Snyder "C" Lease, all on lands located in Howard County, Texas. The said partnership had on that date, May 19, 1948, owned said leaseholds and interests therein, and each of them, for several years, during all of which time they were held by said partnership for productive use in its trade or business, and not as stock in trade or primarily for sale.

(e) On May 19, 1948, Fleming Oil Company aforesaid conveyed to Mrs. Marie Hildreth Cline, limited overriding royalty or oil-payment interests from the leasehold interest described in the for-going subparagraph (d), by virtue of which she, the said Marie Hildreth Cline, became the owner of fractional parts of the oil and gas then under the said lands, and became entitled to receive, sell and dispose [fol. 233] of the same when, as and if produced, until she had received from this source oil and gas of the value of $147,000, plus an amount equal to that which interest would produce when calculated at the rate of 5% per annum upon the amount of said $147,000 remaining from month to month unsatisfied. The fractional interest so conveyed in each and all of said leases was 1/2 of 7/8ths, except as to the Denman "H" Lease, as to which the fractional interest conveyed was 1/2 of 13 16ths. Fleming Oil Company received from the

said Marie Hildreth Cline, as the sole consideration for the properties so conveyed her, an undivided 50% fee simple interest in approximately 2,994.5 acres of ranch lands in Parker and Tarrant Counties, Texas, this ranch being known as the Cline Ranch. Said partnership acquired the said interest in said Cline Ranch for investment, and has continued to hold the same for that purpose since it was so acquired.

(f) Being advised and believing that the gain from the aforesaid exchange was not to be recognized in determining its income for the year 1948 because of the provisions of Section 112(b)(1) of the Internal Revenue Code, Fleming Oil Company reported no gain or loss from said transaction in its income tax return for the year 1948. Upon an investigation of said partnership tax return and the return for 1948 of these petitioners, the respondent made the following determinations:

(1) That the market value of said 50% interest in said Cline Ranch on May 19, 1948, was $147,000.

[fol. 234] (2) That the net basis in the hands of said partnership for the interests in said oil and gas leases so conveyed to Marie Hildreth Cline was $1,102.70.

(3) That said $147,000 (the value of a 50% undivided interest in said Cline Ranch) constituted ordinary income of Fleming Oil Company for the calendar year 1948.

(4) That the aforesaid amount of $147,000 represented income from the respective oil and gas leases heretofore referred to, so that said partnership was entitled to deduct an allowance for depletion equal to 27½% of said gross income, or $40,425.

(5) That said partnership's net income from said exchange was $106,575.

(g) In accordance with the determinations set out in the preceding subparagraph (f), the respondent increased the taxable income of said partnership for the year 1948 in the amount of $106,575 and added a ratable portion thereof (61.026%) to the taxable income of petitioners for the year 1948 as otherwise adjusted. A substantial portion of the deficiency here involved results from this action.

(h) On May 19, 1948, petitioner Wm. Fleming was, among other business activities, engaged in the business of acquiring oil and gas properties, developing them and

producing oil and gas therefrom. On that date the said Wm. Fleming owned a 41.667 working interest in an oil and gas lease and leasehold estate conveyed thereby on lands in Eddy County, New Mexico, this oil and gas lease being [fol. 235] known as the State (Choate) Lease. The said Wm. Fleming had owned this lease for several years prior to May 19, 1948, during all of which time he held same for productive use in his trade or business of producing oil and gas and not as stock in trade and not primarily for sale. On said date, the said Wm. Fleming conveyed to the aforesaid Marie Hildreth Cline a limited overriding royalty interest in said State (Choate) Lease, by which she, the said Marie Hildreth Cline, became the owner of 40% of 41.667% of the oil and gas then in and under said lands and thereafter to be produced from same, until she had received oil and gas of the value of $73,500 plus an amount equal to that which interest would produce when calculated at the rate of 5% per annum upon the said amount of $73,500 remaining from month to month unsatisfied. As the sole consideration for said transfer, the said Marie Hildreth Cline conveyed to petitioner Wm. Fleming an undivided one-fourth fee simple interest in the aforesaid Cline Ranch. Petitioner Wm. Fleming acquired said undivided interest in said ranch for investment, and since its acquisition has continued to hold the same solely for that purpose.

(i) Being advised and believing that the gain from the aforesaid exchange was not to be recognized in determining his income for the year 1948, because of the provisions of Section 112(b)(1) of the Internal Revenue Code, petitioners reported no gain or loss from the said transaction in their income-tax return for the year 1948. Upon an investigation of said tax return, the respondent made the following determinations:

[fol. 236] (1) That an undivided one-fourth fee simple interest in said Cline Ranch had a fair market value on May 19, 1948 of $73,500.

(2) That said sum of $73,500 constituted a part of petitioners' gross income for 1948 from the aforesaid State (Choate) Lease.

(3) That petitioners were entitled to an allowance for depletion with respect to said amount of $73,500 equal to 27½% thereof, or $20,212.50.

(4) That petitioners derived taxable ordinary income from said exchange of $53,287.50. Accordingly, respondent added said amount of $53,287.50 to petitioners' income for the year 1948 as otherwise adjusted, and a substantial portion of the deficiency here involved is based upon this determination.

(j) Petitioners allege upon information and belief that the respondent erred in determining that the gain of the partnership Fleming Oil Company, and of petitioners and each of them, from the aforesaid exchanges was to be recognized in determining the income of said partnership for 1948 and in determining the income of petitioners for the year 1958. Petitioners further allege upon information and belief that said exchanges and each of them constituted exchanges of properties of like kind within the purview of Section 112(b)(1) of the Internal Revenue Code, and that none of the excepting provisions of said section applies to either of said exchanges.

(k) Alternatively, petitioners say that if they be mistaken [fol. 237] in the position heretofore advanced, that said exchanges and each of them came within the non recognition-of-gain provisions of Section 112(b)(1) of the Internal Revenue Code, then the gain regulsting to said partnership and to these petitioners from the transactions was taxable as long-term capital gain derived from the exchange of capital assets within the purview of Section 117 of the Internal Revenue Code, and the respondent erred in failing so to hold in determining the deficiency here involved.

Wherefore, the petitioners pray that this Court may hear the proceeding and upon such hearing hold and determine (a) that the aforesaid exchanges and each of them gave rise to gain which was not to be recognized because of the provisions of Section 11(b)(1) of the Internal Revenue Code, or alternatively (b) that the gain resulting from the aforesaid exchanges and each of them was taxable as long-term capital gain under Section 117 of the Internal Revenue Code; and that they may have such other and further relief as may be entitled to receive under the facts alleged.

Harry C. Weeks, Counsel for Petitioners.

525 Fort Worth National Building Fort Worth, Texas.

Of counsel: Weeks, Bird, Gannon & Appleman, Fort Worth, Texas.

STATE OF TEXAS,
County of Tarrant:

Wm. Fleming and Bessie M. Fleming, being each duly sworn, say that they are the petitioners above named; that [fol. 238] each has read the foregoing petition and is familiar with the statements contained therein, and that the statements contained therein are true except those stated to be upon information and belief, and that those each believes to be true.

Wm. Fleming, Bessie M. Fleming.

Subscribed and sworn to before me this 29 day of January, 1953.

Mamie Morse, Notary Public in and for Tarrant County, Texas. (Seal.)

EXHIBIT A TO PETITION

U. S. Treasury Department

Office of Internal Revenue Agent in Charge, Mercantile Commerce Building, Dallas 1, Texas

Dallas
IRA :90D-D

Nov. 10, 1952.

Mr. Wm. Fleming, and Mrs. Bessie M. Fleming, Husband and Wife, 1218 Fair Building, Forth Worth, Texas.

DEAR MR. AND MRS. FLEMING:

You are advised that the determination of your income tax liability for the taxable years ended December 31, 1948 [fol. 239] and 1949 discloses a deficiency of $94,113.30 and $1,307.70, respectively, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United

States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia, in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidsys are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to this office for the attention of C:RLP. The signing and filing of this form will expedite the closing of your returns by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earlier.

Very truly yours, John B. Dunlap, Commissioner, by (Signed) A. H. Hertwig, Acting Internal Revenue Agent in Charge.

Enclosures: Statement, Form 1276, Agreement Form.
GN:esk.

[fol. 240] Dallas
IRA:90D-D

Statement

Mr. Wm. Fleming, and Mrs. Bessie M. Fleming, Husband and Wife, 1218 Fair Building, Fort Worth, Texas

Income Tax Liability for the Taxable Years Ended December 31, 1948 and 1949

Year	Deficiency
1948	$94,113.30
1949	1,307.70
Total	$95,421.00

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated September 5, 1951; to your protest dated January 15, 1952; and to the statements made at the conference held on April 2, 1952.

A copy of this letter and statement has been mailed to your representative, Mr. Harry C. Weeks, Fort Worth National Bank Building, Fort Worth, Texas, in accordance with the authority contained in the power of attorney executed by you and on file in this office.

[fol. 241]

Schedule 1

Taxable Year Ended December 31, 1948

Adjustments to Net Income

Net income as disclosed by joint return		$151,621.67
Additional income:		
(a) Business income increased	$3,044.96	
(b) Capital loss reduced	2,121.53	
(c) Income from partnerships	70,309.80	
(d) Income from other sources	53,287.50	
Total	$128,763.79	
Additional deduction:		
(e) Contributions	6,110.75	
Net addition to income		122,653.04
Net income adjusted		$274,274.71

Schedule 1-A

Explanation of Adjustments

(a) Business income reported has been increased, as follows:

Collection on oil payment omitted	$60.03
Repairs to personal residence and boathouse, disallowed	1,116.24
Excessive depreciation on lease equipment	2,321.34
Additional depletion allowed	(452.65)
Net Adjustment	$3,044.96

[fol. 242] (b) Capital loss reported has been reduced by the net of the following items:

Sherman Oil & Gas Company stock sold (Basis of ½ reduced to estate tax valuation)	$425.00
Socony-Vacuum gain reduced	(4.60)
Fleming Oil Company (Exhibit A) ½ of both interests	893.85
Fleming and Kimball, gain	807.28
Net adjustment	$2,121.53

(c) Ordinary income reported from partnerhips has been increased, as follows:

Fleming & Kimball:		
As corrected	$17,647.72	
Reported	15,573.12	
Increase		$2,074.60
Fleming Oil Company:		
As corrected (Exhibit A)—		
Salary	$12,500.00	
Wm. Fleming	65,370.39	
Estate	65,370.39	
Total	$143,240.78	
Reported	75,005.58	
Increase		$68,235.20
Eddleman Oil Company (not changed)		
Total increase		$70,309.80

[fol. 243] (d) Your gain on the exchange of an oil payment, face amount $73,500.00, plus 5% interest payable out of 40% of 41.667 W.I. in State (Choate) Lease, Eddy County, New Mexico, for a ¼ undivided interest in 2.994½ acres in Parker and Tarrant Counties, Texas, has been computed as follows:

Consideration, fair market value of land received, held to be face value of oil payments—	
¼ of $294,000.00	$73,500.00
Cost basis of oil payment assigned, depletion, 27½ of $73,500.00	20,212.50
Income increased	$53,287.50

(e) The entire amount of contributions, $32,867.52, is allowable after above adjustments are applied to adjusted gross income, instead of $26,756.77 per return on additional deduction of the difference, $6,110.75.

Schedule 2

Computation of Tax

Net income		$274,274.71
Less: Exemptions (3 x $600)		1,800.00
Income subject to tentative tax		$272,474.71
½ of $272,474.71, joint return		$136,237.36
Tentative tax		$99,571.25 (1)
Tax reduction:		
$68 plus 12% of $99,171.25		11,968.55 (2)
[fol. 244]		
Combined normal tax and surtax, (1) minus (2)		$87,602.70
Multiply $87,602.70 by 2, for tax liability		$175,205.40
Income tax liability disclosed by return, Account #3194733		81,092.10
Deficiency in income tax		$94,113.30

Schedule 3

Taxable Year Ended December 31, 1949

Adjustments to Net Income

Net income as disclosed by joint return		$64,597.92
Unallowable deductions and additional income:		
(a) Business income increased	$1,706.51	
(b) Capital loss reduced	31.19	
(c) Income from partnerships	1,017.24	
Total	$2,754.94	
Nontaxable income and additional deductions:		
(d) Contributions	413.25	
Net addition		2,341.69
Net income adjusted		$66,939.61

[fol. 245] Schedule 3-A

Explanation of Adjustments

(a) Omission in summary on return:		
Collection oil payments, page 19	$8,613 13	
Carried to summary	6,007 65	$2,605 48
Repairs, 75% of $1,775.34 claimed is disallowed as repairs, being a capital expenditure		1,331 50
Repairs to residence and boathouse		1,616 56
Loss on sale of cars for personal use		1,639 50
Excessive depreciation		1,755 34
Additional depletion		(7,241 87)
Net adjustment		$1,706 51

(b) Loss on sale of capital assets is decreased by your distributive share of the gain of Fleming and Kimball, $62.38, of which 50%, or $31.19, is taken into account.

(c) Ordinary net income from partnerships reported in your return has been increased as follows:

Fleming and Kimball:		
As corrected	$13,090 14	
Reported	11,628 04	$1,462 1[illegible]
Fleming Oil Company:		
As corrected, Exhibit B—		
Salary	$12,500 00	
Wm. Fleming	11,647 76	
Estate	11,647 76	
Total	$35,795 52	
[fol. 246]		
Reported	36,120 36	
Overstated		(324 84)
Eddleman Oil (No change)		
Fleming Ranch Company		(120 02)
Net addition		$1,017 24

(d) An additional deduction for contributions is allowed, as follows:

Total contributions, $125,370.86.	
Adjusted gross income per return	$75,997 55
Adjustments (a), (b), and (e) above	2,754 94
Total	$78,752 49
Amount allowable, 15% of $78,752.49	$11,812 88
Amount claimed	11,399 63
Additional deduction	$413 25

Schedule 4

Computation of Tax

Net income from Schedule 3	$66,939 61
Less: Exemptions (3 x $600)	1,800 00
Income subject to tentative tax	$65,139 61
½ of $65,139.61, joint return	$32,569 81
Tentative tax	$14,830 38 (1)
Tax reduction:	
$68 plus 12% of $14,430.38	1,799 65 (2)

[fol. 247]

Combined normal tax and surtax, (1) minus (2)	$13,030 73
Multiply $13,030.73 by 2 for tax liability	$26,061 46
Income tax liability disclosed by return, Account # B B/R 1	24,753 76
Deficiency in income tax	$1,307 70

Exhibit A

Fleming Oil Company—1948

	Capital Gain	Ordinary Income	Total
Net income per return	$2,870 44	$112,054 06	$114,924 50
Additions:			
(a) Development and production expenses capitalized		1,232 50	
(b) Depreciation disallowed		131 01	
(c) Depletion disallowed		6,745 28	
(d) Gain on sale of equipment	58 98		
(e) Oil payment		106,575 00	
Total additions	$58 98	$114,683 79	$114,742 77
Corrected net income	$2,929 42	$226,737 85	$229,667 27
Less: Salary to Wm. Fleming		12,500 00	12,500 00
Income to be distributed	$2,929 42	$214,237 85	$217,167 27

[fol. 248]

Distribution:

	Percentage	Capital Gain	Ordinary Income	Total
Wm. Fleming	30.513%	$893 85	$65,370 39	$66,264 24
Estate, A. M. Fleming	30.513%	893 85	65,370 39	66,264 24
Wm. Fleming, Trustee	38.974%	1,141 72	83,497 07	84,638 79
Totals	100%	$2,929 42	$214,237 85	$217,167 27

Contributions:

Wm. Fleming	$310 01
Estate, A. M. Fleming	310 01
Wm. Fleming, Trustee	395 98
Total	$1,016 00

Exhibit B

Fleming Oil Company—Year 1949

Net income per return		$51,205.40
Addition:		
Development expense	$425.00	
Additional deductions:		
Depreciation	$306.97	
Loss on sales	260.45	
Fleming Ranch income overstated	240.00	
Depletion	149.88	
Total additional deductions	$957.30	
[fol. 249]		
Net deduction		532.30
Net income as corrected		$50,673.10
Salary to Wm. Fleming		12,500.00
Amount to be distributed		$38,173.10

Distribution:

	Rate	Amount	Contributions per Returns
Wm. Fleming	30.513%	$11,647.76	$855.13
Estate of A. M. Fleming	30.513%	11,647.76	855.13
Wm. Fleming, Trustee	38.974%	14,877.58	1,092.24
Totals	100%	$38,173.10	$2,802.50

IN THE TAX COURT OF THE UNITED STATES

Docket No. 46781

F. HOWARD WALSH and MARY D. WALSH (Husband and Wife) Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

PETITION—Filed February 5, 1953

The above-named petitioners hereby petition for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency

(Bureau Symbols Dallas-IRA:90D-H) dated November 10, 1952, and as a basis for their proceeding allege as follows:

[fol. 250]

I

The petitioners are individuals. They are now, and were at all pertinent times hereafter referred to, husband and wife. They reside in Fort Worth, Texas, and their office is at 1701 Fair Building, Fort Worth, Texas. The returns for the periods here involved were filed with the Collector of Internal Revenue of the Second Collection District of Texas at Dallas, Texas.

II

The notice of deficiency (a copy of which is attached and marked Exhibit "A") was mailed to the petitioners on November 10, 1952.

III

The deficiencies, as determined by the respondent, are in income taxes for the calendar years 1948 and 1949, in the amounts of $2,301.31 and $38,550.52, respectively, substantially all of which is in dispute.

IV

The determination of tax set forth in said notice of deficiency is based upon the following errors:

(b) The respondent erroneously failed to determine that [fol. 251] petitioners' gain from the exchange of certain limited overriding royalty interests in oil and gas leaseholds for urban real estate was within the purview of Section 112(b)(1) of the Internal Revenue Code, so that said gain was not to be recognized in determining petitioners' taxable income for 1949.

(c) Alternatively, the respondent erred in failing to determine that the gain from the exchange, referred to in subparagraph (b) above, was taxable as long-term capital gain, rather than as ordinary income subject to depletion.

(d) Respondent erroneously determined the income of Wm. Fleming, Trustee for the fiscal years of said Trust ended August 31, 1948, and August 31, 1949, and therefore erroneously determined the share of said income taxable to petitioners for the calendar years 1948 and 1949.

V

The facts upon which the petitioners rely as the basis for this proceeding are as follows:

(a) Throughout the applicable periods herein referred to petitioners were husband and wife, residing together in Fort Worth, Texas. They kept their books and records upon the cash receipt and disbursement basis and duly filed joint income tax returns for the calendar years 1948 and 1949 upon that basis, and for calendar year periods.

(b) Throughout the years 1948 and 1949, petitioner, Mary D. Walsh, was the beneficiary of a Trust known as Wm. Fleming, Trustee, of which Wm. Fleming, 1218 Fair [fol. 252] Building, Forth Worth, Texas, was the Trustee. This Trust kept its books and records upon the cash receipt and disbursement basis and upon the basis of a fiscal year ending on August 31. It duly filed income tax returns as a fiduciary with the Collector of Internal Revenue for the Second Collection District of Texas for the fiscal years ending August 31, 1948 and August 31, 1949. These returns were filed upon such cash receipt and disbursement basis.

[fol. 253] (c) On October 5, 1949, the petitioners owned ordinary commercial oil and gas leases and the leasehold estates conveyed thereby, or interests therein, in and with respect to various lands in Ward County, Texas. These interests, and each of them, had been owned by petitioners for more than six months prior to said date of October 5, 1949, and during all of that time had been held by petitioners for productive use in their trade or business of producing oil and gas, and not as stock in trade or primarily for sale. On said date, to wit, October 5, 1949, petitioners conveyed to one C. C. Cross limited overriding royalty or oil payment interests out of said leases and leaseholds, by virtue of which the said C. C. Cross became the owner of 1/4th of 7/8ths of the oil and gas then under said lands, and each of them, except as to one tract as to which the fractional interest was 1/4th of 7/16ths, and of the same part [fol. 254] of the oil and gas thereafter to be produced from said lands until he, the said C. C. Cross, had received oil and gas of a value of $65,000, plus an amount equal to that which interest would produce when calculated at the rate of 7 per cent per annum on the amount of said sum of

$65,000 remaining from month to month unsatisfied. Petitioners received as the sole and only consideration for the limited overriding royalty interest so transferred, and in exchange therefor, improved real estate located in Tarrant County, Texas. Petitioners acquired said Tarrant County real estate for investment and have continued to hold the same for investment since it was so acquired.

(f) Being advised and believing that the gain from the aforesaid exchange was not to be recognized in determining their income for 1949, because of the provisions of Section 112(b)(1) of the Internal Revenue Code, petitioners reported no gain or loss from said transaction in their income tax return for the year 1949. Upon an investigation of said 1949 tax return, the respondent made the following determinations:

1. That the market value of said Tarrant County real estate on October 5, 1949, was $65,000.

2. That the limited overriding royalty interests, so transferred to the said C. C. Cross, had no cost or basis in the hands of the petitioners.

3. That said sum of $65,000 constituted a part of petitioners' gross income from the leaseholds, from which the overriding royalties came, as to which petitioners were entitled to an allowance for depletion equal to 27½ per cent of said amount, or $17,875.

[fol. 255] 4. That petitioners' net income from said exchange was $47,125.

(g) In accordance with the determinations set out in the preceding Subparagraph (f), respondent increased the taxable income of petitioners for the year 1949 in the amount of $47,125. A substantial portion of the deficiency asserted against the petitioners for the year 1949, and here involved, results from this action.

(h) Petitioners allege upon information and belief that the respondent erred in determining that the gain of petitioners from the aforesaid exchange was to be recognized in determining their taxable income for the year 1949. Petitioners further allege upon information and belief that the said exchange constituted an exchange of properties of a like kind within the purview of Section 112(b)(1) of

the Internal Revenue Code, and that none of the excepting provisions of said section applies to said exchange.

(i) Alternatively, petitioners say that if they be mistaken in the position heretofore advanced that said exchange came within the non-recognition of gain provisions of Section 112(b)(1) of the Internal Revenue Code, then the gain resulting to petitioners from the said transaction was long-term capital gain derived from the exchange of capital assets within the purview of Section 117 of the Internal Revenue Code, and the respondent erred in failing so to hold in determining the deficiencies here involved.

(j) There was distributed to petitioner, Mary D. Walsh, by Wm. Fleming, Trustee aforesaid in the year 1948, and from the income of said Trust for its fiscal year ended Au- [fol. 256] gust 31, 1948, the sum of $10,000; and there was likewise distributed to said petitioner, Mary D. Walsh, from the income of said Trust for its fiscal year ended August 31, 1949, and during the year 1949, the sum of $27,000. The respondent has determined the deductions for depletion and depreciation allowable to petitioners with respect to said distributions, and the portions thereof taxable to petitioners as capital gain on the basis of his determinations of the net taxable income of said Trust for its fiscal years ended August 31, 1948, and August 31, 1949. The correctness of these determinations, as to the income of said Trust for these periods, is in issue in a proceeding which has been heretofore filed in this Court, or will shortly hereafter be filed in this Court, from a notice of transferee liability mailed to petitioner, Mary D. Walsh, on November 2, 1952. Petitioners say that the proper treatment of said distributions, in determining the tax-liability of these petitioners can only be determined after the net income of said Trust for said two fiscal periods has been determined. The petition filed, or to be filed, in said transferee proceeding is incorporated herein by reference.

Wherefore, the petitioners pray that this Court may hear the proceeding, and upon such hearing hold and determine:

(b) That the aforesaid exchange gave rise to gain which was not to be recognized because of the provisions of Section 112(b)(1) of the Internal Revenue Code.

[fol. 257] (c) Alternatively, that the gain resulting from the aforesaid exchange was taxable as long-term capital gain under Section 117 of the Internal Revenue Code; and

(d) That their incomes for 1948 and 1949 from Wm. Fleming, Trustee be adjusted to conform with the final determinations of taxable income made in the aforesaid transferee proceeding; and that they have such other and further relief as they may be entitled to receive under the facts alleged.

Harry C. Weeks, Counsel for Petitioners.

525 Fort Worth National Bank Building, Fort Worth, Texas.

Of Counsel: Weeks, Bird, Cannon & Appleman, Fort Worth, Texas.

State of Texas,
County of Tarrant:

F. Howard Walsh and Mary D. Walsh, being each duly sworn, say that they are the petitioners above named; that each has read the foregoing petition and is familiar with the statements contained therein, and that the statements contained therein are true, except those stated to be upon information and belief, and that those each believes to be true.

Mar D. Walsh, (F. Howard Walsh), Mary D. Walsh.

[fol. 258] Sworn to and subscribed before me this the 31st day of January, A. D. 1953.

Marguerite Shepherd, Notary Public in and for Tarrant County, Texas. (Seal.)

EXHIBIT A TO PETITION

U. S. Treasury Department

Office of Internal Revenue Agent in Charge, Mercantile Commerce Building, Dallas 1, Texas.

Dallas
IRA:90D-H

Nov. 10, 1952

Mr. F. Howard Walsh, and Mrs. Mary D. Walsh, Husband and Wife, 1701 Fair Building, Fort Worth, Texas.

DEAR MR. AND MRS. WALSH:

You are advised that the determination of your income tax liability for the taxable years ended December 31, 1948 and 1949 discloses a deficiency of $2,301.31 and $38,550.52, respectively, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

[fol. 259] Within 90 days from the date of the mailing of this letter you may file a petition with the Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia, in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to this office for the attention of C:RLP. The signing and filing of this form will expedite the closing of your returns by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earlier.

Very truly yours, John B. Dunlap, Commissioner, By A. H. Hertwig, Acting Internal Revenue Agent in Charge.

Enclosures: Statement, Form 1276, Agreement Form, GN:esk.

[fol. 260] Statement

Mr. F. Toward Walsh, and Mrs. Mary D. Walsh, Husband and wife, 1710 Fair Building, Fort Worth, Texas.

Income Tax Liability for the Taxable Years Ended December 31, 1948 and 1949

Year	Deficiency
1948	$ 2,301.31
1949	38,550.52
Total	$40,851.83

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated September 5, 1951; to your protest dated January 17, 1952; and to the statements made at the conference held on April 2, 1952.

A copy of this letter and statement has been mailed to your representative, Mr. Harry C. Weeks, Fort Worth National Bank Building, Fort Worth, Texas, in accordance with the authority contained in the power of attorney executed by you and on file in this office.

Schedule 1

Taxable Year Ended December 31, 1948.
Adjustments to Net Income.

Net income as disclosed by joint return		$97,513.72
[fol. 261]		
Unallowable deductions and additional income:		
(a) Interest income	$2,872.10	
(b) Capital gain	8,226.29	
(c) Partnership income	858.40	
Total	$11,956.79	
Additional deduction:		
(d) Trust income overstated	6,590.08	
Net addition		5,366.71
Net income adjusted		$102,880.43

Schedule 1-A

Explanation of Adjustments

(a) It is held that you received taxable income from contracts with life insurance companies, as follows:

1. Pan-American Life Insurance Company (Policy #274-057) paid	$ 739.92
2. Southwestern Life Insurance Company (Deferred payment agreements #462429-T and #484414) credited	2,132.18
Total	$2,872.10

1. Before maturity of a 10-year endowment policy, Mrs. Walsh (then Mary D. Fleming) executed a settlement agreement under which the company was to retain the net proceeds for a period not exceeding 30 years with interest at a rate not less than 3% per annum to be paid Mrs. [fol. 262] Walsh monthly. The net proceeds of the policy were to be paid to her executors upon her death or to her if she lived through the 30-year period. The amount received in 1948, $739.92, was omitted from taxable income on your return and is therefore, included here.

2. On July 13, 1943 after maturity date November 2, 1942 of a single-premium endowment policy, Mrs. Walsh entered into a contract for deferment of payment in which the company guaranteed an addition to the policy of not less than 3½% per annum on the unpaid portion of the proceeds until November 2, 1952 and thereafter payment monthly to Mrs. Walsh of such interest as it accrued. The amount accrued and credited to this policy in 1948, $2,132.18, is included in income.

(b) Capital gain distributed to Mrs. Walsh from Wm. Fleming Trust. See Exhibit A. Capital gains received and omitted, $8,226.29.

(c) Your share of income from the partnership, Walsh and Watts, was found to be $22,538.93 instead of $21,680.53, an additional amount of $858.40.

(d) Ordinary income from Wm. Fleming, Trustee, has been adjusted to accord with Exhibit A.

Amount reported	$8,165.73
Amount, Exhibit A	1,575.65
Reduction in taxable income	$6,590.08

[fol. 263] Schedule 2

Computation of Income Tax

Adjusted net income	$102,880.43
Less: Exemptions (6 x 600)	3,600.00
Income subject to tentative tax	$ 99,280.43
½ of $99,280.43, joint return	$ 49,640.22
Tentative normal tax and surtax	$ 26,560.96
Less: $68 plus 12% of excess tax over $400.00	3,207.32
Combined normal tax and surtax	$ 23,353.64
Multiply $23,353.64 by 2 for joint return	$ 46,707.28
Alternative tax, Schedule 3	$ 45,418.49
Income tax previously assessed	43,117.18
Deficiency in income tax	$ 2,301.31

Schedule 3

Computation of Alternative Tax

Income subject to tentative tax, ½	$ 49,640.22
Less: 50% excess of net long-term capital gain, over short-term capital losses ($9,646.69)	4,823.35
Balance taxable	$ 44,816.87
Tentative Tax	$ 23,088.15
Less: $68 plus 12% of excess over $400.00	2,790.58
Combined partial normal and surtax	$ 20,297.57
Multiply $20,297.57 by 2, joint return	$ 40,595.14
Add: 50% excess of net long-term capital gain over short-term and capital losses	4,823.35
Alternative tax, to Schedule 2	$ 45,418.49

[fol. 264] Schedule 4

Taxable Year Ended December 31, 1949

Adjustments to Net Income

Net income as disclosed by joint return		$141,593.89
Unallowable deductions and additional income:		
(a) Interest	$2,946.73	
(b) Rents	528.87	
(c) Ordinary income from trust	2,029.25	
(d) Other income	47,125.00	52,629.85
Net income adjusted		$194,223.74

Schedule 4-A

Explanation of Adjustments

(a) It is held that in 1949 as in 1948 (see Schedule 1-A (a) for explanation), you received taxable income from contracts with life insurance companies. The amounts paid or credited in 1949 are as shown below:

Pan-American Life Insurance Company, paid to you	$ 739.92
Southwestern Life Insurance Company, credited to you	2,206.81
Total	$ 2,946.73

(b) Rental income has been increased by the net of the following adjustments:

[fol. 265] Capital items (abstract, taxes accrued at date of purchase, etc.)	$ 534.41
Insurance premium applicable to 1950 and 1951, disallowed	548.98
Total	$ 1,083.39
Depreciation allowed (4% on $55,452.11 3 months)	554.52
Net addition to income	$ 528.87

(c) Income received from Wm. Fleming, Trustee, is adjusted per Exhibit A.

Ordinary income	$ 21,843.11
Per return	19,813.86
Addition	$ 2,029.25

Note: The capital gain of $98.06 shown on Exhibit A reduces the capital loss carry-over to 1950 by that amount.

(d) It is held that the execution of an oil payment contract in the amount of $65,000.00 to Mrs. C. C. Cross in exchange for land and improvements of a like value resulted in taxable income to you. The amount shown was payable out of 1/4 of 7/8 production from the Ward County leases known as—

Walsh's Richter A, B & C Leases (4 20-acre tracts)
Walsh's Green Lease
Walsh's Maxwell A Lease
Walsh's Maxwell B Lease
Walsh's Wallis Lease

[fol. 266] Also, out of 1/4 of 7/16 of production on Walsh's Killough Lease, also in Ward County.

Since your costs of these leases had been recovered through depletion prior to sale, there is no cost involved in the following computation.

Consideration	$ 65,000.00
Depletion at 27½%	17,785.00
Taxable income	$ 47,125.00

Schedule 5

Computation of Tax

Adjusted net income	$194,223.74
Less: Exemptions (6 x $600)	3,600.00
Income subject to tax	$190,623.74
½ of $190,623.74, joint return	$ 95,311.87
Tentative Tax	$ 63,241.33
Less: $68 plus 12% of excess over $400.00	7,608.96
Combined normal tax and surtax	$ 55,632.37
Multiply $55,632.37 by 2 for tax liability	$111,264.74
Income tax per return, Account #BF 308	72,714.22
Deficiency in income tax	$ 38,550.52

[fol. 267]

EXHIBIT A

Adjustments to Net Income

	Year Ended August 31, 1948				Year Ended August 31, 1949			
	Per Return 8-31-1948		Additions to Income (Deductions)	Corrected	Per Return 8-31-1949		Additions to Income (Deductions)	Corrected
Dividends and interest	$2,550.00			$2,550.00	$4,775.00			$4,775.00
Partnership income	83,959.72	(a)	$2,116.94	86,076.66	42,380.84	(a)	$43,062.17	85,443.01
Sale of equipment	(20.60)			(20.60)				
Capital gains	681,013.28	(b)	13,846.62	694,859.90		(b)	570.86	570.86
Business	8,051.35			8,051.35	66,387.86			66,387.86
Other sources		(c)	53,165.03	53,165.03				
Total income	$775,553.75		$69,128.59	$844,682.34	$113,543.70		$43,633.03	$157,176.73
Depletion	$16,827.50	(d)	$496.93	$16,330.57	$26,956.54	(c)	$665.33	$26,291.21
Depreciation	390.82			390.82	3,158.11			3,158.11
Other deductions	670.16	(e)	670.16		395.98	(d)	395.98	
Total deductions	$17,888.48		$1,167.09	$16,721.39	$30,510.63		$1,061.31	$29,449.32
Remainder of income	$757,665.27		$70,295.68	$827,960.95	$83,033.07		$44,694.34	$127,727.41
Distributions	(8,165.73)	(f)	(1,636.21)	(9,801.94)	(19,813.86)	(e)	(2,127.31)	(21,941.17)
Net income	$749,499.54		$68,659.47	$818,159.01	$63,219.21		$42,567.03	$105,786.24

EXHIBIT A—Continued

Explanation—Year 1948

(a) Ordinary income from the partnership Fleming Oil Company increased as agreed by partners for calendar year year 1947, $2,116.94.

(b) Capital gains of Fleming Oil Company increased as agreed to by the partners, year 1947, 3,846.62.

(c) Exchange of royalty interests for 2,994½ A. of land—Gain $53,287.50
Less Loss by death of cattle 122.47
Net increase in income $53,165.03

(d) Depletion claimed was excessive by $496.93.

(e) Contributions are considered in (a), $670.16.

(f) Distribution $10,000.00. Ratio of total income, $844,682.34, to net income of $827,900.95 is .980194. Therefore, amount of taxable distribution is $9,801.94.

Capital gain	$8,226.29
Ordinary income	1,575.65
Total	$9,801.94

Explanation—Year 1949

(a) Ordinary income from Fleming Oil Company

Ordinary income	$83,497.07
Per return	39,918.92
Additional income	$43,578.15
Fleming Ranch Company, income reduced	120.00
Net increase	$43,458.15
Less: Contributions	395.98
Adjustment	$43,062.17

(b) Capital gain Fleming Oil Company, $1,141.72. Amount taxable, 5%, $570.86.

(c) Excessive depletion, $665.33.

(d) Contributions in (a) above.

(e) Net income, $127,727.41, is 81.26358% of total income, $157,176.73; amount of distributions ($27,000.00) deductible is 81.26358% of $27,000, or $21,941.17.

Capital gain	$98.06
Ordinary income	21,843.11
Total	$21,941.17

[fol. 268] IN THE TAX COURT OF THE UNITED STATES.

Docket No. 46782

MARY D. FLEMING WALSH, Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

PETITION—Filed Feb. 5, 1953

The above-named petitioner hereby petitions for a redetermination of the deficiency or alleged liability as a transferee set forth by the Commissioner of Internal Revenue in his notice of deficiency and alleged transferee liability (Bureau symbols Dallas—IRA: 90D—D), dated November 10, 1952, and as a basis of her proceedings alleges as follows:

1

The petitioner is an individual. She resides in Fort Worth, Texas, and her office is at 1701 Fair Building, Fort Worth, Texas. The returns of her alleged transferor for the periods here involved were filed with the Collector of Internal Revenue for the Second Collection District, at Dallas, Texas.

2

The notice of deficiency and alleged transferee liability (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on November 10, 1952.

[fol. 269] 3

The deficiency as determined by the respondent is in income tax claimed to be due by Wm. Fleming, Trustee, for its fiscal years ended August 31, 1948 and August 31, 1949, in the amounts of $51,976.17 and $31,218.55, respectively, and the transferee liability asserted is against petitioner as the alleged transferee of the assets of Wm. Fleming, Trustee.

4

The determination of the tax liability of Wm. Fleming, Trustee, set forth in said notice of deficiency is based on the following errors:

(a) The respondent erroneously failed to determine that the gain derived by Wm. Fleming, Trustee, from the exchange of certain limited overriding royalty interests in oil and gas leaseholds for an undivided interest (in fee simple) in ranch lands was within the provisions of Section 112(b)(1) of the Internal Revenue Code, so that the said gain was not to be recognized in determining the taxable income of Wm. Fleming, Trustee, for its fiscal year ended August 31, 1948.

(b) The respondent erroneously failed to determine that the gain derived by a partnership (Fleming Oil Company), of which Wm. Fleming, Trustee, was a member, from the exchange of certain limited overriding royalty interests in oil and gas leaseholds for an undivided interest (in fee simple) in ranch lands came within the provisions of Section 112(b)(1) of the Internal Revenue Code, so that the [fol. 270] said gain was not to be recognized in determining the net income of said partnership for the calendar year 1948, and in determining the distributive share of said partnership income upon which Wm. Fleming, Trustee, was to be taxed in its fiscal year ended August 31, 1949.

(c) Alternatively, the respondent erred in failing to determine that the gain from the exchanges referred to in sub-paragraphs (a) and (b), above, was taxable as long-term capital gain, rather than as ordinary income subject to depletion.

The determination of transferee liability set forth in said notice of deficiency is based on the erroneous determination by the respondent that petitioner was liable as a transferee, for the deficiencies in income tax so asserted against Wm. Fleming, a trustee, in said notice.

5

The fact on which the petitioner relies as a basis of her proceeding are as follows:

(a) Petitioner at all pertinent times involved herein was the beneficiary of a trust known as, "Wm. Fleming,

Trustee," of which Wm. Fleming, 1218 Fair Building, Fort Worth, Texas, was the trustee. Said trust kept its books and records on the cash receipts and disbursements basis, and for fiscal year periods ending on August 31. It duly filed income tax returns for its fiscal years ended August 31, 1948 and August 31, 1949, on the cash receipts and disbursements basis, and for such fiscal-year periods.

[fol. 271] (b) Throughout the fiscal years of Wm. Fleming, Trustee, ended August 31, 1948 and August 31, 1949 as well as prior and subsequent thereto, there existed a partnership known as Fleming Oil Company, which had its office and place of business at 1218 Fair Building, Fort Worth, Texas. The said trust was a member of this partnership. This partnership was engaged primarily in the business of acquiring, developing and operating oil and gas properties, but, from time to time, made other investments. This partnership kept its books and records on the cash receipts and disbursements basis and accounted for calendar-year periods, and it duly filed income tax returns on such basis and for such periods. At all of the times involved in this proceeding, the interest of Wm. Fleming, Trustee, in said partnership was 38.974%.

(c) On May 19, 1948, the said partnership Fleming Oil Company owned ordinary commercial oil and gas leases, or interests therein, on lands located in Texas. These leaseholds were known as the Denman "C" Lease, the Denman "H" Lease, the Reid "A" and "B" Leases, and the Snyder "C" Lease, all on lands located in Howard County, Texas. The said partnership had on that date, May 19, 1948, owned said leaseholds and interests therein, and each of them, for several years, during all of which time they were held by said partnership for productive use in its trade or business, and not as stock in trade or primarily for sale.

(d) On May 19, 1948, Fleming Oil Company aforesaid conveyed to Mrs. Marie Hildreth Cline, limited overriding royalty or oil payment interests from the leasehold interest described in the foregoing subparagraph (c), by virtue of [fol. 272] which she, the said Marie Hildreth Cline, became the owner of fractional parts of the oil and gas then under the said lands, and became entitled to receive, sell and dispose of the same, when, as and if produced, until she had received from this source oil and gas of the value of

$147,000, plus an amount equal to that which interest would produce when calculated at the rate of 5% per annum upon the amount of said $147,000 remaining from month to month unsatisfied. The fractional interest so conveyed in each and all of said leases was 1/2 of 7/8ths, except as to the Denman "H" Lease, as to which the fractional interest conveyed from 1/2 of 13 16ths. Fleming Oil Company received from the said Marie Hildreth Cline, as the sole consideration for the properties so conveyed to her, an undivided 50% fee simple interest in approximately 2,994.5 acres of ranch lands in Parker and Tarrant Counties, Texas, this ranch being known as the Cline Ranch. Said partnership acquired the said interest in said Cline Ranch for investment, and has continued to hold the same for that purpose since it was so acquired.

(e) Being advised and believing that the gain from the aforesaid exchange was not to be recognized in determining its income for the year 1948 because of the provisions of Section 112 (b)(1) of the Internal Revenue Code, Fleming Oil Company reported no gain or loss from said transaction in its income tax return for the year 1948. Upon an investigation of said partnership return and the return of Wm. Fleming, Trustee for its fiscal year ended August 31, 1949, the respondent made the following determinations:

(1) That the market value of said 50% interest in said Cline Ranch on May 19, 1948 was $147,000.

[fol. 273] (2) That the net basis in the hands of said partnership for the interests in said oil and gas leases so conveyed to Marie Hildreth Cline was $1,102.70.

(3) That said $147,000 (the value of a 50% undivided interest in said Cline Ranch, constituted ordinary income of Fleming Oil Company for the calendar year 1948.

(4) That the aforesaid amount of $147,000 represented income from the respective oil and gas leases heretofore referred to, so that said partnership was entitled to deduct an allowance for depletion equal to 27 1/2% of said gross income, or $40,425.

(5) That said partnership's net income from said exchange was $106,575.

(f) In accordance with the determination set out in the preceding subparagraph (e), the respondent increased the taxable income of said partnership for the year 1948

in the amount of $106,575 and added a ratable portion thereof (38.974%) to the taxable income of Wm. Fleming, Trustee for the fiscal year ended August 31, 1948, as otherwise adjusted. A substantial portion of the deficiency so determined in Exhibit A attached hereto against Wm. Fleming, Trustee for its fiscal year ended August 31, 1949, results from this action.

(g) On May 19, 1948, Wm. Fleming, Trustee was, among other business activities, engaged in the business of acquiring oil and gas properties, developing them, and producing oil and gas therefrom. On that date, Wm. Fleming, Trustee owned an interest in an ordinary commercial [fol. 274] oil and gas lease, and the leasehold estate conveyed thereby, covering lands in Gregg County, Texas, known as the J. M. Christian Lease, and also owned a mineral or royalty interest on lands in Cook County, Texas, known as the Ramsey Royalty. Wm. Fleming, Trustee had owned these properties for several years prior to May 19, 1948, during all of which time they had been held for productive use in said trust's trade or business or producing oil and gas, and not as stock in trade and not primarily for sale. On said date, the said Wm. Fleming, Trustee conveyed to the aforesaid Marie Hildreth Cline limited overriding royalty interests in the above described properties by which she, the said Marie Hildreth Cline, became the owner of 6 10ths of 1 10ths of 7sths of the oil and gas in and under said J. M. Christian leaseholds and thereafter to be produced from same, until she had received oil and gas of the value of $49,000, plus an amount equal to that which interest would produce when calculated at the rate of five per cent per annum on the said amount of $49,000 remaining from month to month unsatisfied, and by which she, the said Marie Hildreth Cline, became the owner of 32.335 400ths of 1/2 of 1/8th of the oil and gas in and under the lands covered by said Ramsey Royalty and thereafter to be produced from same, until she had received oil and gas of the value of $24,500, plus an amount equal to that which interest would produce when calculated at the rate of five per cent on the said amount of $24,500 remaining from month to month unsatisfied. As the sole consideration for said transfer, the said Marie Hildreth Cline conveyed to Wm. Fleming, Trustee an undivided 1/4th fee simple interest in the aforesaid Cline Ranch. Wm. Fleming,

Trustee acquired said undivided interest in said Ranch for investment, and continued to hold the same solely for that purpose until the termination of said trust on November [fol. 275] 30, 1950, after which it was held for investment by petitioner herein.

(h) Being advised and believing that the gain from the aforesaid exchange was not to be recognized in determining the income tax liability of Wm. Fleming, Trustee for its fiscal year ended August 31, 1948, because of the provisions of Section 112(b)(1), of the Internal Revenue——, the trustee of said trust reported no gain or loss from said transaction in the income tax return filed for said trust for the fiscal year ended August 31, 1948. Upon an investigation of said tax return, the respondent made the following determinations:

(1) That an undivided 1/4th fee simple interest in said Cline Ranch had a fair market value on May 19, 1948 of $73,500.

(2) That said sum of $73,500 constituted a part of the gross income of Wm. Fleming, Trustee for its fiscal year ended August 31, 1948 from the aforesaid J. M. Christian and Ramsey Royalty properties.

(3) That Wm. Fleming, Trustee was entited to an allowance for depletion with respect to said sum of $73,500 equal to 27½% thereof, or $20,212.50.

(4) That the interest in said J. M. Christian and Ramsey Royalty properties so conveyed by Wm. Fleming, Trustee to Marie Hildreth Cline had a net cost or basis in the hands of Wm. Fleming, Trustee totaling $18,119.21.

(5) That Wm. Fleming, Trustee derived taxable ordinary income from said exchange of $53,287.50. Accord- [fol. 276] ingly, respondent added said amount of $53,287.50 to the income of Wm. Fleming, Trustee, for the fiscal year ended August 31, 1948, as otherwise adjusted, and a substantial portion of the deficiency determined to be due by Wm. Fleming, Trustee for that fiscal year, as shown in Exhibit A attached hereto, is based upon this determination.

(i) Petitioner alleges, upon information and belief, that the respondent erred in determining that the gain of the partnership Fleming Oil Company and of Wm. Fleming, Trustee from the aforesaid exchanges was to be recognized

in determining the income of said partnership for the year 1948 and in determining the income of Wm. Fleming, Trustee for its fiscal years ended August 31, 1948 and 1949. Petitioner further alleges, upon information and belief, that said exchanges, and each of them, constituted exchanges of property of like kind within the provisions of Section 112(b)(1) of the Internal Revenue Code, and that none of the excepting provisions of said section applies to either of said exchanges.

(j) Alternatively, petitioner says that, if she be mistaken in the position heretofore advanced, that said exchanges and each of them came within the non-recognition-of-gain provisions of Section 112(b)(1), of the Internal Revenue Code; then the gain so resulting to said partnership and to Wm. Fleming, Trustee from said transactions was taxable as long-term capital gain derived from the exchange of capital assets within the purview of Section 117 of the Internal Revenue Code, and the respondent erred in failing so to hold in determining the deficiencies asserted against Wm. Fleming, Trustee, as shown in Exhibit A hereto attached.

[fol. 277] Wherefore, the petitioner prays that this Court may hear the proceeding and, on such hearing, hold and determine (a) that the aforesaid exchanges and each of them gave rise to gain which was not to be recognized because of the provisions of Section 112(b)(1) of the Internal Revenue Code; or, alternatively (b) that the gain resulting from the aforesaid exchanges, and each of them, was taxable as long-term capital gain under Section 117 of the Internal Revenue Code; and (c) that the petitioner is not liable for the deficiencies determined against Wm. Fleming, Trustee, and that she may have such other and further relief as she may be entitled to receive under the facts alleged.

Harry C. Weeks, Attorney for Petitioner.

525 Fort Worth National Building,
Fort Worth, Texas.

Of Counsel: Weeks, Bird, Cannon & Appleman, Fort Worth, Texas.

STATE OF TEXAS,
County of Tarrant:

Mary D. Fleming Walsh, being duly sworn, says that she is the petitioner above named; that she has read the foregoing petition and is familiar with the statements contained therein, and that the statements contained therein are true, except those stated to be upon information and belief, and that those she believes to be true.

Mary D. Fleming Walsh.

[fol. 278] Subscribed and sworn to before me, this 31st day of January, 1953.

Marguerite Shepherd, Notary Public in and for Tarrant County, Texas. (Seal.)

(Copy)

EXHIBIT "A" TO PETITION

U. S. Treasury Department

Office of Internal Revenue Agent in Charge, Mercantile-Commerce Building, Dallas 1, Texas

Dallas
IRA:90D-D

November 10, 1952.

Mrs. Mary D. Fleming Walsh, 1701 Fair Building, Fort Worth, Texas.

DEAR MRS. WALSH:

You are advised that the determination of the income tax liability of Wm. Fleming, Trustee, 1218 Fair Building, Fort Worth, Texas, for the taxable years ended August 31, 1948, 1949, and 1950, discloses deficiencies of $51,976.17 and $31,218.55, respectively, for the taxable years ended August 31, 1948 and 1949, and an overassignment of $218.27 for the taxable year ended August 31, 1950, as shown in the statement attached. The amount of the deficiencies stated, plus interest as provided by law, constituting your liability as

transferee of assets of said Wm. Fleming, Trustee, will [fol. 279] be assessed against you. The overassessment, to the extent that it represents an overpayment of tax, will be credited in the manner provided by law.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia, in which event that day is not counted as the 90th day. otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to this office for the attention of C:RLP. The signing and filing of this form will expedite the closing of your returns by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earlier.

Yours very truly, John B. Dunlap, Commissioner, by (Signed) E. A. Peavy, Internal Revenue Agent in Charge.

[fol. 280] Enclosures: Statement, Form 1276, Agreement Form, Form 843.

Statement

Wm. Fleming, Trustee, Transferor, 1218 Fair Building, Fort Worth, Texas

Income Tax Liability for the Taxable Years Ended August 31, 1948, 1949 and 1950

Mrs. Mary D. Fleming Walsh, Transferee, 1701 Fair Building, Fort Worth, Texas

Year Ended	Overassessment	Deficiency
August 31, 1948		$51,976 17
August 31, 1949		31,218 55
August 31, 1950	$218 27	
Totals	$218 27	$83,194 72

The records of this office show that assets of the trust, Wm. Fleming, Trustee, were transferred to you in 1950.

The amounts shown above represent your liability as transferee of Wm. Fleming, Trustee, for unpaid income taxes for the fiscal years ended August 31, 1948, 1949 and 1950.

[fol. 281] The overassessment shown herein will be made the subject of a certificate of overassessment which will reach you in due course through the office of the collector of internal revenue for your district, and will be applied by that official in accordance with section 322 of the Internal Revenue Code, provided that you fully protect yourself against the running of the statute of limitations with respect to the apparent overassessment referred to in this letter, by filing with the collector of internal revenue for your district, a claim for refund on form 843, a copy of which is enclosed, the basis of which may be as set forth herein.

A copy of this letter and statement has been mailed to your representative, Mr. Harry C. Weeks, Fort Worth National Bank Building, Fort Worth, Texas, in accordance with the authority contained in the power of attorney executed by you and on file in this office.

The computation of the taxes shown above for which you are liable is set out in the attached schedules.

Schedule 1

Taxable Year Ended August 31, 1948
Adjustments to Net Income

	Per Return 8-31-1948		Additions to income (Deductions)	Corrected
Dividends and interest	$2,550.00			$2,550.00
Partnership income, [fol. 282]	83,959.72	(a)	$2,116.94	86,076.66
Sale of equipment	(20.60)			(20.60)
Capital gains	681,013.28	(b)	13,846.62	694,859.90
Business	8,051.35			8,051.35
Other sources		(c)	53,165.03	53,165.03
Total income	$775,553.75		$69,128.59	$844,682.34
Depletion	$16,827.50	(d)	$496.93	$16,330.57
Depreciation	390.82			390.82
Other deductions	670.16	(e)	670.16	
Total deductions	$17,888.48		$1,167.09	$16,721.39
Remainder of income	$757,665.27		$70,295.68	$827,960.95
Distributions	(8,165.73)	(f)	(1,636.21)	(9,801.94)
Net income	$749,499.54		$68,659.47	$818,159.01

(a) Ordinary income from the partnership, Fleming Oil Company, increased as agreed by partners for calendar year 1947, $2,116.94.

(b) Capital gains of Fleming Oil Company increased as agreed to by the partners, year 1947, $13,846.62.

(c) Exchange of royalty interest for 2,994½ A. of land.

Gain	$53,287.50
Less loss by death of cattle	122.47
Net increase in income	53,165.03

(d) Depletion claimed was excessive by $496.93.

[fol. 283] (e) Contributions are considered in (a), $670.16.

(f) Distribution, $10,000.00; Ratio of total income $844,682.34 to net income of $827,960.95 is .980194. Therefore, amount of taxable distribution is $9,801.94.

Schedule 2

Computation of Income Tax

Adjusted net income	$818,159.01
Less: Excess net long-term capital gain over net short-term capital losses	686,633.61
Net ordinary income	$131,525.40
Less: Exemption	100.00
Balance subject to tax	$131,425.40
Normal and surtax (at 1947 rates)	$ 95,288.61
Less: 5% reduction	4,764.43
Balance	$ 90,524.18
Alternative tax on capital gain (½ of $686,633.61)	343,316.81
Total tax at 1947 rates	$433,804.99
Allocated to 1947 (122/366) .33333	$144,612.22
Normal and surtax (based on 1948 rates)	$ 95,288.61
Less: $68 plus 12% of excess over $400.00	11,454.63
Balance	$ 83,833.98
Alternative tax on capital gain	343,316.81
Total tax at 1948 rates	$427,150.79
[fol. 284] Allocated to 1948 (244/366) .66667	$284,768.62
Total tax (1947 rates)	$144,612.22
Total tax (1948 rates)	284,768.62
Tax liability	$429,380.84
Total tax previously assessed, Account #355003	377,404.67
Deficiency	$ 51,976.17

Schedule 3

Taxable Year Ended August 31, 1949

Adjustments to Net Income

	Per Return 8 31 1949		Additions to income (Deductions)	Corrected
Dividends and interest	$4,775 00			$4,775 00
Partnership income	42,380 84	(a)	$43,062 17	85,443 01
Capital gains		(b)	570 86	570 86
Business	66,387 86			66,387 86
Total income	$113,543 70		$43,633 03	$157,176 73
Depletion	$26,956 54	(c)	$665 33	$26,291 21
Depreciation	3,158 11			3,158 11
Other deductions	395 98	(d)	395 98	
Total deductions	$30,510 63		$1,061 31	$29,449 32
Remainder of income	$83,033 07		$44,694 34	$127,727 41
Distributions	(19,813 86)	(e)	(2,127 31)	(21,941 17)
Net income	$63,219 21		$42,567 03	$105,786 24

[fol. 285] (a) Ordinary income from Fleming Oil Company:

Ordinary income, Exhibit A	$83,497.07
Per return	39,918.92
Additional income	$43,578.15
Fleming Ranch Company, income reduced	120.00
Net increase	$43,458.15
Less: Contributions	395.98
Adjustment	$43,062.17

(b) Capital gain, Fleming Oil Company, per Exhibit A $ 1,141.72
Amount taxable, 5% 570.86

(c) Excessive depletion, $665.33.

(d) Contributions in (a) above.

(e) Net income, $127,727.41, is 81.26358% of total income, $157,176.73. Amount of distributions ($27,000.00) deductible is 81.26358% of $27,000.00, or $21,941.17.

Schedule 4

Computation of Income Tax

Adjusted net taxable income	$105,786.24
Less: Excess of net long-term capital gain over net short-term losses	472.80
Net ordinary income	$105,313.44
Less: Exemption	100.00
[fol. 286] Income for normal tax and surtax	$105,213.44
Total normal and surtax	$ 71,959.96
Less: $68 plus 12% of excess over $400.00	8,655.19
Partial tax	$ 63,304.77
Alternative tax on line 2 above (½ of $472.80)	236.40
Income tax liability	$ 63,541.17
Income tax previously assessed, Account #355005	32,322.62
Deficiency	$ 31,218.55

Schedule 5

Taxable Year Ended August 31, 1950

Adjustments to Net Income

	Per Return 8-31-1950		Additions to income (Deductions)		Corrected
Dividends and interest	$4,188.60				$4,188.60
Partnership income	13,916.11		($1,419.69)	(a)	12,496.42
Business	25,140.33	(b)	(32.01)		25,108.32
Total income	$43,245.04		($1,451.70)		$41,793.34
Other deductions	1,092.24	(c)	1,092.24		
Remainder of income	$42,152.80		(359.46)		$41,793.34
Distributions	None				None
Net income	$42,152.80				$41,793.34

[fol. 287] (a) Income from partnership, Fleming Oil Company:

Per Exhibit B	$14,877.58
Less: Contributions	1,092.24
Net amount	$13,785.34
Fleming Ranch Company, loss as corrected	1,288.93
Corrected amount	$12,496.41

(b) Additional depletion $32.01.
(c) Considered in adjustment (a).

Schedule 6

Computation of Income Tax

Adjusted net income	$41,793.34
Less: Exemption	100.00
Income for normal tax and surtax	$41,693.34
Total normal and surtax	$20,908.40
Less: $68 plus 12% of excess over $400.00	2,529.01
Tax liability	$18,379.39
Tax previously assessed, Account 1950 NOV FT 20	18,597.66
Overassessment	$ 218.27

[fol. 288] EXHIBIT A

Fleming Oil Company—Year 1948

	Capital Gain	Ordinary Income	Total
Net income per return	$2,870 41	$112,054 06	$114,924 50
Additions:			
(a) Development and Production expenses capitalized		1,232 50	
(b) Depreciation disallowed		131 01	
(c) Depletion disallowed		6,745 28	
(d) Gain on sale of equipment	58 98		
(e) Oil payment		106,575 00	
Total additions	$58 98	$114,683 79	$114,742 77
Corrected net income	$2,929 42	$226,737 85	$229,667 27
Less: Salary to Wm. Fleming		12,500 00	12,500 00
Income to be distributed	$2,929 42	$214,237 85	$217,167 27

Distribution:

	Percentage	Capital Gain	Ordinary Income	Total
Wm. Fleming	30.513%	$893 85	$65,370 39	$66,264 24
Estate A. M. Fleming	30.513%	893 85	65,370 39	66,264 24
Wm. Fleming, Trustee	38.974%	1,141 72	83,497 07	84,638 79
Totals	100.000%	$2,929 42	$214,237 85	$217,167 27

[fol. 289]

Contributions:

Wm. Fleming	$310 01
Estate A. M. Fleming	310 01
Wm. Fleming, Trustee	395 98
Total	$1,016 00

Exhibit B

Fleming Oil Company—Year 1949

Net income per return		$51,205 40
Addition:		
Development expense	$425 00	
Additional deductions:		
Depreciation	$306 97	
Loss on sales	260 45	
Fleming Ranch income overstated	240 00	
Depletion	149 88	
Total additional deductions	$957 30	
Net deduction		532 30
Net income as corrected		$50,673 10
Salary to Wm. Fleming		12,500 00
Amount to be distributed		$38,173 10
Distribution:		

	Rate	Amount	Contributions per Return
Wm. Fleming	30.513%	$11,647 76	$855 13
Estate of A. M. Fleming	30.513%	11,647 76	855 13
Wm. Fleming, Trustee	38.974%	14,877 58	1,092 24
Totals	100%	$38,173 10	$2,802 50

[fol. 290] In the Tax Court of the United States

Docket No. 46713

Wm. Fleming and Bessie M. Fleming (husband and wife), Petitioners,

v.

Commissioner of Internal Revenue, Respondent

Answer—Filed March 19, 1953

Comes now the Commissioner of Internal Revenue, by his attorney, Charles W. Davis, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed in the above-entitled appeal, admits and denies as follows:

1, 2 & 3

Admits the allegations contained in paragraphs 1, 2 and 3 of the petition.

4

(a) to (e), inclusive. Denies that respondent's determination is based upon errors as alleged in subparagraphs (a) to (e), inclusive, of paragraph 4 of the petition.

5

(a) to (e), inclusive. Admits the material allegations of fact set forth in subparagraphs (a) to (e), inclusive, of paragraph 5 of the petition.

[fol. 291] (d) Admits that on May 19, 1948, the said partnership, Fleming Oil Company, owned ordinary commercial oil and gas leases, or interests therein, on lands located in Texas. Admits these leaseholds were known as the Denman "C" Lease, the Denman "H" Lease, the Reid "A" and "B" Leases, and the Snyder "C" Lease, all on lands located in Howard County, Texas. Denies the remaining material allegations of fact set forth in subparagraph (d) of paragraph 5 of the petition.

(e) Admits that on May 19, 1948, Fleming Oil Company aforesaid conveyed to Mrs. Marie Hildreth Cline oil-payment interests from the leasehold interest described in the foregoing subparagraph (d). Admits that Fleming Oil Company received from the said Marie Hildreth Cline, as the sole consideration for the properties so conveyed to her, an undivided 50% fee simple interest in approximately 2,994.5 acres of ranch lands in Parker and Tarrant Counties, Texas, this ranch being known as the Cline Ranch. Denies the remaining material allegations of fact set forth in subparagraph (e) of paragraph 5 of the petition.

(f) Admits Fleming Oil Company reported no gain or loss from said transaction in its income tax return for the year 1948. Admits that upon an investigation of said partnership return and the return for 1948 of these petitioners, the respondent made the following determination:

(1) That the market value of said 50% interest in said Cline Ranch on May 19, 1948 was $147,000.

(2) That the net basis in the hands of said partnership for the interests in said oil and gas leases so conveyed to Marie Hildreth Cline was $1,102.79.

[fol. 292] (3) That said $147,000 (the value of a 50% undivided interest in said Cline Ranch) constituted ordi-

nary income of Fleming Oil Company for the calendar year 1948.

(4) That the aforesaid amount of $147,000 represented income from the respective oil and gas leases heretofore referred to, so that said partnership was entitled to deduct an allowance for depletion equal to 27½% of said gross income, or $40,425.

(5) That said partnerships net income from said exchange was $106,575.

Denies the remaining material allegations of fact set forth in subparagraph (f) of paragraph 5 of the petition.

(g) Admits the material allegations of fact set forth in subparagraph (g) of paragraph 5 of the petition.

(h) Admits that on May 19, 1948, petitioner Wm. Fleming was, among other business activities, engaged in the business of acquiring oil and gas properties, developing them and producing oil and gas therefrom. Admits that on that date the said Wm. Fleming owned a 41.667 working interest in an oil and gas lease and leasehold estate conveyed thereby on lands in Eddy County, New Mexico, this oil and gas lease being known as the State (Choate) Lease. The said Wm. Fleming had owned this lease for several years prior to May 19, 1948. Admits that on said date the said Wm. Fleming conveyed to the aforesaid Marie Hil- [fol. 293] dreth Cline a limited overriding royalty interest in said State (Choate) Lease. Admits that as the sole consideration for said transfer, the said Marie Hildreth Cline conveyed to petitioner Wm. Fleming an undivided one-fourth fee simple interest in the aforesaid Cline Ranch. Denies the remaining material allegations of fact set forth in subparagraph (h) of paragraph 5 of the petition.

(i) Admits that petitioners reported no gain or loss from the said transaction in their income tax return for the year 1948. Admits that upon an investigation of said tax return the respondent made the following determinations:

(1) That an undivided one-fourth fee simple interest in said Cline Ranch had a fair market value on May 19, 1948, of $73,500.

(2) That said sum of $73,500 constituted a part of petitioner's gross income for 1948 from the aforesaid State (Choate) Lease.

(3) That petitioners were entitled to an allowance for depletion with respect to said amount of $73,500 equal to 27½% thereof or $20,212.50.

(4) That petitioners derived taxable ordinary income from said exchange of $53,287.50. That accordingly respondent added said amount of $53,287.50 to petitioners' income for the year 1948 as otherwise adjusted, and a substantial portion of the deficiency here involved is based upon this determination.

Denies the remaining material allegations of fact set forth in subparagraph (1) of paragraph 5 of the petition. [fol. 294] (j) and (k) Denies the material allegations of fact set forth in subparagraphs (j) and (k) of paragraph 5 of the petition.

Denies generally and specifically each and every allegation set forth in the petition not hereinbefore expressly admitted, qualified or denied.

Wherefore, it is prayed that the petitioners' appeal be denied and that the Commissioner's determination be approved.

(Signed) Charles W. Davis, JMK, Chief Counsel, Bureau of Internal Revenue.

Of Counsel: James L. Backstrom, District Counsel; Allen T. Akin, Appellate Counsel, J. Marvin Kelley, Special Attorney, Bureau of Internal Revenue, 2nd Floor Mercantile Commerce Building, Dallas 1, Texas.
JMK:jr 3-11-53.

[fol. 295] IN THE TAX COURT OF THE UNITED STATES.

Docket No. 46781

F. HOWARD WALSH AND MARY D. WALSH, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

ANSWER—Filed Mar. 19, 1953

Comes now the Commissioner of Internal Revenue, by his attorney, Charles W. Davis, Chief Counsel, Bureau of

Internal Revenue, and for answer to the petition filed in this proceeding admits and denies as follows:

I—III

Admits the allegations contained in paragraphs I, II, and III, of the petition.

IV

(a)—(d) Denies that the respondent erred in the manner alleged in subparagraphs (a) to (d), inclusive, of paragraph IV, of the petition.

V

(a)—(b) Admits the allegations contained in subparagraphs (a) and (b) of paragraph V, of the petition.

(c) Admits on April 28, 1935 petitioner, Mary D. Walsh, acquired from Pan American Life Insurance Company its [fol. 296] ten year endowment policy No. 274-057 in consideration of an annual premium of $2,248.50, and further payments of a like amount until ten annual premiums had been paid; also admits that the provisions of the policy and the settlement agreement dated November 26, 1943 speak for themselves; that under and in accordance with this settlement provision, petitioner, Mary D. Walsh, received in each of the years 1948 and 1949—$739.92; that the respondent, in determining the deficiencies here involved, treated said sums as interest income derived by petitioners, but denies the remaining allegations contained in subparagraph (c) of paragraph V, of the petition.

(d) Admits on November 2, 1937 petitioner, Mary D. Walsh acquired, for a single premium of $25,000.09 from Southwestern Life Insurance Company its five-year endowment policy No. 347,056 in the face amount of $28,744, to be paid as designated in said policy at its maturity date, to-wit, November 2, 1942; also admits that the agreement with respect to deferment of the amount to be paid and the ultimate payment will speak for itself; that in determining the deficiencies here involved, the respondent added to the petitioners' income for the year 1948, $2,132.18 and, for the year 1949, $2,206.81, but denies the remaining allegations contained in subparagraph (d) of paragraph V, of the petition.

(e) Admits on October 5, 1949 the petitioners owned ordinary commercial oil and gas leases and the lease hold estates conveyed thereby, or interests therein, in and with respect to various lands in Ward County, Texas; that on said date, to-wit, October 5, 1949 petitioners conveyed to [fol. 297] one C. C. Cross limited oil payment interests out of said leases and lease-holds; that petitioners received in exchang therefor, improved real estate located in Tarrant County, Texas but denies the remaining allegations contained in subparagraph (e) of paragraph V, of the petition.

(f) Admits petitioners reported no gain or loss from said transaction in their income tax return for the year 1949; that upon an investigation of said 1949 tax return the respondent made the following determinations:

1. That the market value of said Tarrant County real estate on October 5, 1949 was $65,000.

2. That the limited overriding royalty interests, so transferred to the said C. C. Cross, had no cost or basis in the hands of the petitioners.

3. That said sum of $65,000 constituted a part of petitioners' gross income from the leaseholds, from which the overriding royalties came, as to which petitioners were entitled to an allowance for depletion equal to 27½ per cent of said amount, or $17,875.

4. That petitioners' net income from said exchange was $47,125.,

but denies the remaining allegations contained in subparagraph (f) of paragraph V, of the petition.

(g) Admits the allegations contained in subparagraph (g) of paragraph V, of the petition.

(h)—(i) Denies the allegations contained in subparagraphs (h) and (i) of paragraph V, of the petition.

[fol. 298] (j) Admits the allegations contained in subparagraph (j) of paragraph V, of the petition.

Denies generally and specifically each and every allegation contained in the petition not hereinbefore expressly admitted, qualified or denied.

Wherefore, it is prayed the determination of the Commissioner be sustained.

(Signed) Charles W. Davis, JMK, Chief Counsel, Bureau of Internal Revenue.

Of Counsel: James L. Backstrom, District Counsel, Allen T. Akin, Appellate Counsel, J. Marvin Kelley, Special Attorney, Bureau of Internal Revenue.
JMK/lmm 3/11/53

[fol. 299] IN THE TAX COURT OF THE UNITED STATES

Docket No. 46782.

MARY D. FLEMING WALSH, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

ANSWER—Filed Mar. 19, 1953

Comes now the Commissioner of Internal Revenue, by his attorney, Charles W. Davis, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed in this proceeding admits, alleges and denies as follows:

1-3

Admits the allegations contained in paragraphs 1, 2, and 3, of the petition.

4

(a)—(e) Denies that the respondent erred in the manner alleged in subparagraphs (a) to (e), inclusive, of paragraph 4, of the petition, and denies the allegations contained in the unlettered subparagraph at the closing of paragraph 4, of the petition.

5

(a)—(b) Admits the allegations contained in subparagraphs (a) and (b) of paragraph 5, of the petition.
[fol. 300] (c) Admits on May 19, 1948 the partnership Fleming Oil Company owned ordinary commercial oil and

gas leases, or interests therein, on lands located in Texas; that these leaseholds were known as the Denman "C" Lease, the Denman "H" Lease, the Reid "A" and "B" Leases, and the Snyder "C" Lease, all on lands located in Howard County, Texas, but denies the remaining allegations contained in subparagraph (c) of paragraph 5, of the petition.

(d) Admits on May 19, 1948 Fleming Oil Company aforesaid, conveyed to Mrs. Marie Hildreth Cline oil payment interests from the leasehold interest described in the foregoing subparagraph (c); that Fleming Oil Company received from the said Marie Hildreth Cline, as the sole consideration for the properties so conveyed to her, an undivided 50% fee simple interest in approximately 2,994.5 acres of ranch lands in Parker and Tarrant Counties, Texas, this ranch being known as the Cline Ranch, but denies the remaining allegations contained in subparagraph (d) of paragraph 5, of the petition.

(e) Admits Fleming Oil Company reported no gain or loss from said transaction in its income tax return for the year 1948; that upon an investigation of said partnership return and the return of Wm. Fleming, Trustee for its fiscal year ended August 31, 1949 the respondent made the following determination:

(1) That the market value of said 50% interest in said Cline Ranch on May 19, 1948 was $147,000.

(2) That the net basis in the hands of said partnership for the interests in said oil and gas leases so conveyed to Marie Hildreth Cline was $1,102.70.

[fol. 304] (3) That said $147,000 (the value of a 50% undivided interest in said Cline Ranch) constituted ordinary income of Fleming Oil Company for the calendar year 1948.

(4) That the aforesaid amount of $147,000 represented income from the respective oil and gas leases heretofore referred to, so that said partnership was entitled to deduct an allowance for depletion equal to 27½% of said gross income, or $40,425.

(5) That said partnership's net income from said exchange was $106,575.

but denies the remaining allegations contained in subparagraph (e) of paragraph 5, of the petition.

(f) Admits the allegations contained in subparagraph (f) of paragraph 5, of the petition.

(g) Admits on May 19, 1940 Wm. Fleming, Trustee was, among other business activities, engaged in the business of acquiring oil and gas properties, developing them, and producing oil and gas therefrom; that on that date, Wm. Fleming, Trustee owned an interest in an ordinary commercial oil and gas lease, and the leasehold estate conveyed thereby, covering lands in Gregg County, Texas known as the J. M. Christian Lease, and also owned a mineral or royalty interest on lands in Cook County, Texas, known as the Ramsey Royalty; that on said date, the said Wm. Fleming, Trustee conveyed to the aforesaid Marie Hildreth Cline limited overriding royalty interest in the above described properties; that as the sole consideration for said transfer, the said Marie Hildreth Cline conveyed to Wm. Fleming [fol. 302] Trustee, an undivided 1/4th fee simple interest in the aforesaid Cline Ranch, but denies the remaining allegations contained in subparagraph (g) of paragraph 5, of the petition.

(h) Admits the trustee of said trust reported no gain or loss from said transaction in the income tax return filed for said trust for the fiscal year ended August 31, 1948; that upon an investigation of said tax return, the respondent made the following determinations:

(1) That an undivided 1/4th fee simple interest in said Cline Ranch had a fair market value on May 19, 1948 of $73,500.

(2) That said sum of $73,500 constituted a part of the gross income of Wm. Fleming, Trustee for its fiscal year ended August 31, 1948 from the aforesaid J. M. Christian and Ramsey Royalty properties.

(3) That Wm. Fleming, Trustee was entitled to an allowance for depletion with respect to said sum of $73,500 equal to 27½% thereof, or $20,212.50.

(4) That the interest in said J. M. Christian and Ramsey Royalty properties so conveyed by Wm. Fleming, Trustee to Marie Hildreth Cline had a net cost or basis in the hands of Wm. Fleming, Trustee totaling $18,119.21.

(5) That Wm. Fleming, Trustee derived taxable ordinary income from said exchange of $53,287.79. Accordingly, respondent added said amount of $53,287.50 to the income of

[fol. 303] Wm. Fleming, Trustee, for the fiscal year ended August 31, 1948 as otherwise adjusted, and a substantial portion of the deficiency determined to be due by Wm. Fleming, Trustee for that fiscal year, as shown in Exhibit A, attached to the petition, is based upon this determination, but denies the remaining allegations contained in subparagraph (h) of paragraph 5, of the petition.

(i) (j) Denies the allegations contained in subparagraph (i) and (j) of paragraph 5, of the petition.

Denies generally and specifically each and every allegation contained in the petition not hereinbefore expressly admitted, qualified or denied.

(6) Further answering, respondent alleges:

(a) That on November 30, 1950, the trust created on December 30, 1933 in which Mary D. Fleming (now Mary D. Fleming Walsh) was beneficiary, which trust is known as Wm. Fleming, Trustee, was terminated and all assets of every kind and description belonging to the trust were transferred and conveyed to the beneficiary, Mary D. Fleming Walsh.

(b) That as a result of said conveyance to the petitioner herein, Wm. Fleming, Trustee, was left without assets to satisfy its tax liability.

(c) That the taxes asserted in the notice of deficiency or liability attached to the petition are due and payable.

Wherefore, it is prayed that petitioner's appeal be denied, that the deficiencies as determined by respondent [fol. 304] be, in all respects, approved, and that petitioner be held to be liable at law and in equity as a transferee of the assets of Wm. Fleming, Trustee, in the amount shown in the deficiency notice from which this appeal was taken.

(Signed) Charles W. Davis, JMK, Chief Counsel, Bureau of Internal Revenue.

Of Counsel: James L. Backstrom, District Counsel, Allen T. Akin, Appellate Counsel, J. Marvin Kelley, Special Attorney, Bureau of Internal Revenue.
JMK hmm 3/11/53

In the Tax Court of the United States

Docket No. 46782

Mary D. Fleming Walsh, Petitioner,

vs.

Commissioner of Internal Revenue, Respondent

Petitioner's Reply to Respondent's Answer—Filed April 13, 1953

Now comes Mary D. Fleming Walsh, the petitioner in the above styled and numbered cause, by her attorney, [fol. 305] and replies to the affirmative allegations contained in Respondent's answer filed herein on March 15, 1953, which affirmative allegations are contained in Paragraph 6 of said answer, as follows:

1

Petitioner admits the allegations contained in Paragraph 6 (a) of said answer.

2

Petitioner admits the allegations contained in Paragraph 6 (b) of said answer.

3

Petitioner denies the allegations contained in Paragraph 6 (c) of said answer, wherein it is alleged that the taxes asserted in the notice of deficiency or liability attached to the petition are due and payable.

Wherefore, petitioner prays that she be granted the relief prayed for in the petition herein filed.

Harry C. Weeks, Attorney for Petitioner, 525 Forth Worth National Bank Building, Forth Worth, Texas.

Of Counsel: Weeks, Bird, Cannon & Appleman, Fort Worth, Texas.

[fol. 306] IN THE TAX COURT OF THE UNITED STATES

WM. FLEMING and BESSIE M. FLEMING (Husband and Wife) et al.,[1] Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

24 T. C. No. 93

Docket Nos. 46713, 46781, 46782

1 and 2. Exchanges Solely in Kind—Capital Gain—Section 117(j), I.R.C., of 1939.—Petitioners exchanged oil payments for land. Held, that the property was of unlike kind within the meaning of section 112(b)(1), and the gain was taxable as capital gain.

3. Interest—Paid and Accrued.—Under two settlement agreements the proceeds of two endowment policies for petitioner Mary D. Walsh were retained by the insurance company at maturity. In one agreement interest on the retained proceeds was paid to petitioner. Held, that the interest payments were taxable income. Under the other agreement the interest payments were added to the principal sum retained by the insurance company for future distribution. Held, the accrued interest was taxable income to the petitioner in the years before the Court.

[fol. 307] Harry C. Weeks, Esq., for the petitioners.

Daniel A. Taylor, Esq., for the respondent.

OPINION—Filed July 29, 1955

Johnson, Judge: Respondent determined deficiencies in income tax as follows:

Docket No.	Petitioner	Year	Deficiency
46713	Wm. Fleming and Bessie M. Fleming	1948	$94,113.30
46781	F. Howard Walsh and Mary D. Walsh	1948	2,301.31
		1949	38,550.52
46782	Mary D. Fleming Walsh		
		Fiscal year ended 8/31/48	51,976.17
		Fiscal year ended 8/31/49	31,218.55

[1] The following proceedings are consolidated herewith: F. Howard Walsh and Mary D. Walsh (husband and wife), Docket No. 46781; Mary D. Fleming Walsh, Docket No. 46782.

The issues presented are:

(1) Whether an exchange of limited overriding royalties or oil payment interests for the fee simple title to a ranch was an exchange solely in kind under section 112(b)(1), I.R.C. of 1939. In the alternative, if a gain is recognized, is it a capital gain, or ordinary income with depletion allowable?

(2) Would the tax consequences resulting from the exchange above be different where urban real property is substituted for the ranch?

(3) Did petitioners F. Howard Walsh and Mary D. Walsh receive taxable income in 1948 and 1949 because of [fol. 308] certain transactions involving endowment life insurance policies?

Petitioner Mary D. Fleming Walsh has stipulated that she is liable as a transferee for whatever deficiencies in income tax are finally determined against Wm. Fleming, Trustee, for the fiscal years ended August 31, 1948, and August 31, 1949.

All of the facts have been stipulated and are so found and we summarize therefrom as follows:

Wm. Fleming and Bessie M. Fleming were husband and wife, as were F. Howard Walsh and Mary D. Walsh. Mary D. Fleming Walsh (Mary D. Walsh) was also the daughter of Wm. Fleming. All petitioners were residents of Fort Worth, Texas, and their income tax returns were filed on a cash basis with the collector of internal revenue for the second collection district of Texas.

Issue 1

For all the years before us Wm. Fleming was the sole trustee and Mary D. Walsh was the sole beneficiary of the private trust known as "Wm. Fleming, Trustee." This trust was created in 1931 and continued in existence until 1950. The trust kept its books on a cash basis for a fiscal period ending August 31 of each year, and its income tax returns were filed with the collector of internal revenue for the second collection district of Texas.

For the years before us the Fleming Oil Company was a partnership composed of Wm. Fleming and Wm. Flem-

ing, Trustee. The partnership produced oil and gas; and [fol. 309] made investments. Wm. Fleming held a 61.026 per cent interest in the business, and Wm. Fleming, Trustee, a 38.974 per cent interest. Partnership books were kept on a cash basis, and tax returns for the partnership were filed with the collector of internal revenue for the second collection district of Texas.

On May 19, 1948, Marie Hildreth Cline (joined by her husband) conveyed an undivided fee simple title to 2,994.5 acres of ranch land to the Fleming Oil Company (50 per cent), Wm. Fleming, Trustee (25 per cent), and Wm. Fleming (25 per cent). As consideration for this conveyance the grantees of the land conveyed and assigned to Marie Hildreth Cline certain limited overriding royalties or oil payment interest. These limited overriding royalties or oil payment interests came from oil and gas leases, or oil and gas mineral leases, which the transferors had owned for more than six months prior to May 19, 1948, for productive use in their respective trades and businesses and for sale. The ranch was acquired for investment and not for sale.

Pertinent parts of the various oil payments to Marie Hildreth Cline are presented below:

In the first, the Fleming Oil Company, as owner of one-half of seven-eighths of certain oil and gas lease-hold estates:

. . . . does hereby sell, assign, and convey unto the said Mrs. Marie Hildreth Cline, as a part of her separate property and estate, her heirs and assigns, the following described real property, to-wit:

[fol. 310] An overriding royalty and mineral interest carved hereby out of the interest owned by Fleming Oil Company in each and all of the oil and gas leases described above, amounting to an undivided 49/128ths interest in and to all the oil in, under, and that may be produced, saved and marketed from the above described tracts of land under the terms of the oil and gas leases covering same until the grantee named above shall have received therefrom oil of the net value of One Hundred Forty-seven

Thousand Dollars ($147,000.00) plus an amount equal to five per cent (5%) interest per annum from May 19, 1948, on the portions of said $147,000.00 which may be unsatisfied from time to time.

This grant was made subject to certain conditions, limitations, and agreements, such as:

(1) No interest in the gas or casinghead gas in, under, or produced and saved from said tracts, and no interest in the personal property now or hereafter placed thereon is assigned or conveyed to grantee, this conveyance affecting the oil only.

. . . . . .

(5) When and if the grantee herein, her heirs and assigns, have received from the fractional interest hereby assigned, oil of the net value of $147,000.00, plus an amount equal to five per cent (5%) interest as above provided, then the interest hereby conveyed to said grantee shall cease and terminate, and said interest shall revert to, and shall thereafter be owned by grantor, its successors, heirs or assigns; and grantee, her heirs and assigns, shall have [fol. 311] no further interest in said oil and gas leasehold estates covering said land, or in the oil thereunder; and grantee, her heirs or assigns, shall, upon request, execute such instruments as may be necessary or proper to evidence this of record.

(6) The execution of this conveyance shall not impose upon grantor any obligation with respect to developing or operating the property covered hereby, nor shall it be implied herefrom that grantor is in anywise obligated to see that grantee receives oil aggregating the net value of $147,000.00, plus an amount equal to five per cent (5%) interest as above provided, or any lesser sum; but grantor does covenant and agree that grantee shall have the same but no greater right to require grantor to develop and operate said property in accordance with the terms of the original leases upon said property as the original lessors therein, their heirs or assigns, might have or exercise.

Marie Hildreth Cline's share of oil produced from the property described in the Fleming Oil Company assign-

ment, from the effective date of the assignment to the close of 1952, amounted to:

Year	Amount
1948	$15,801.16
1949	22,835.94
1950	31,172.41
1951	31,350.19
1952	30,558.54

In the next oil payment, Wm. Fleming, as owner of an undivided interest in certain oil and gas leases:

[fol. 312] * * * does hereby sell, assigns, and convey unto the said Mrs. Marie Hildreth Cline, as a part of her separate property and estate, and to her heirs and assigns, the following described real property, to-wit:

An overriding royalty and mineral interest carved hereby out of the interest owned by Wm. Fleming in each and all of the oil and gas leases described above, amounting to a .166668 interest in and to all the oil in, under, and that may be produced, saved and marketed from the above described tracts of land under the terms of the oil and gas leases covering same, until the grantee named above shall have received therefrom oil of the net value of Seventy-three Thousand Five Hundred Dollars ($73,500.00), plus an amount equal to five per cent (5%) interest per annum from May 19, 1948, on the portions of said $73,500.00 which may be unsatisfied from time to time.

This grant was also made subject to certain conditions, limitations, and agreements. These were similar to those in the Fleming Oil Company assignment. Marie Hildreth Cline's share of oil produced from this property, from the effective date of the assignment to the close of 1952, amounted to:

Year	Amount
1948	$ 5,423.49
1949	9,412.84
1950	7,916.69
1951	4,854.74
1952	6,420.78

The oil payment from Wm. Fleming, Trustee, conveyed to Marie Hildreth Cline the following described interest:

[fol. 313] An overriding royalty and mineral interest carved hereby out of the interest owned by Wm. Fleming, Trustee, in each and all of the oil and gas leases described above, amounting to an undivided 6-100ths interest in and to 7/8ths of all the oil in, under, and that may be produced, saved and marketed from the above described tract of land under the terms of the oil and gas leases covering same, until the grantee named above shall have received therefrom oil of the net value of Forty-nine Thousand Dollars ($49,000.00), plus an amount equal to five per cent (5%) interest per annum from May 19, 1948, on the portions of said $49,000.00 which may be unsatisfied from time to time.

Like the other grants, this was also subject to certain conditions, limitations, and agreements. Marie Hildreth Cline's share of the oil produced from this property, from the effective date of the assignment to the close of 1952, amounted to:

Year	Amount
1948	$ 4,436.99
1949	7,365.73
1950	7,423.68
1951	7,793.11
1952	7,730.24

Wm. Fleming, Trustee, also conveyed by a mineral deed certain royalty interests to Marie Hildreth Cline as part consideration for the ranch. In this deed the trust did "grant, sell, and convey unto the said grantee, as a part of her separate property and estate, un [sic] undivided 32.3535/400ths royalty interest in and to all of the oil in, [fol. 314] under, and that may be produced from" certain real property. The deed further provided:

Said land being now under an oil and gas lease, it is understood and agreed that this sale is made subject to the terms of said lease, but covers and includes 32.3535/400ths of the 1/8th royalty on oil due and to be paid under the terms of said lease, insofar as it covers the above described land, until the grantee named above shall have received oil of the net value of Twenty-four Thousand Five Hundred Dollars ($24,500.00), plus an amount equal to five

per cent (5%) interest per annum from May 19, 1948, on the portions of said $24,500.00, which may be unsatisfied from time to time.

Like the other grants, this was also made subject to certain conditions, limitation, and agreements. Marie Hildreth Cline's share of the oil produced from this property, from the effective date of the conveyance to the close of 1952, amounted to:

Year	Amount
1948	$ 2,306.57
1949	3,393.20
1950	3,913.38
1951	3,985.71
1952	3,248.27

On the tax returns of Wm. and Bessie M. Fleming, and the Fleming Oil Company (a partnership), for the calendar year 1948, and Wm. Fleming, Trustee, for the fiscal year ended August 31, 1948, the exchange of the ranch for the oil payments was treated as an exchange of property of like kind under section 112(b)(1). However, respondent [fol. 315] determined that they received a gain from this exchange and adjusted their 1948 income accordingly. Respondent explained this adjustment to Wm. and Bessie M. Flemings 1948 net income as follows:

(d) Your gain on the exchange of an oil payment, face amount $73,500.00, plus 5% interest payable out of 40% of 41.667 W.I. in State (Choate) Lease, Eddy County, New Mexico, for a 1/4 undivided interest in 2,994 1/2 acres in Parker and Tarrant Counties, Texas, has been computed as follows:

Consideration, fair market value of land received, held to be face value of oil payments—

1/4 of $294,000.00	$ 73,500.00
Cost basis of oil payment assigned, depletion, 27 1/2% of $73,500.00	20,212.50
Income increased	$ 53,287.50

Respondent's determination, tabulated for each of the assignors, is as follows:

	Fleming Oil Co.	Wm. Fleming	Wm. Fleming Trustee
Fair market value of interest in Cline ranch received	$147,000 00	$73,500 00	$73,500 00
Net cost or basis of property transferred	1,102 70	None	18,119 21
Percentage depletion allowable to	40,425 00	20,212 50	20,212 50
Net income from exchange received	106,575 00	53,287 50	53,287 50

[fol. 316] Since the Fleming Oil Company was a partnership, in the final adjustment respondent distributed the partnership income to the partners; the beneficiary's income from the trust was also adjusted.

The exchanges by Fleming Oil Company, Wm. Fleming and Wm. Fleming, Trustee, of oil payments out of oil and gas leases situated in the Counties of Howard, Gregg and Cooke in the State of Texas and Eddy County, New Mexico, for fee simple title to 2,994½ acres of ranch lands situated in Parker and Tarrant Counties, Texas, were not exchanges of property for property of a like kind and the gain derived therefrom was capital gain. In this first issue the question is whether the exchange here of limited overriding royalties or oil payment interests for the fee simple title to ranch land was an exchange of "property of a like kind" within the meaning of section 112(b)(1) I.R.C. of 1939.[2] If so, petitioners' gain therefrom should not have been recognized in computing their taxable income, since the parties admit the existence of the other requirements of the section. Petitioners contend the properties were of like kind, while respondent determined that they were not.

* * * * * * *

(b) Exchanges Solely in Kind.—

(1) Property Held for Productive Use or Investment.—No gain or less shall be recognized if property held for productive use in trade or business or for investment * * * is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

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[2] Sec. 112. Recognition of Gain or Loss.

[fol. 317] Treasury regulations, in defining the meaning of "like kind" as here used, state that same "have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class." The meaning of the words is there further particularized by citing examples of nontaxable exchanges, which include exchange of "city real estate for a farm or ranch, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate." See Regulations 111, Section 29.112(b)(1)—1.

Similar interpretations have appeared in all of the regulations, beginning with Regulation 62, issued under the Revenue Act of 1921. These have all likewise interpreted the term "like kind", and the statute in question has been repeatedly reenacted by Congress without change since the Revenue Act of 1924. "Under the established rule Congress must be taken to have approved the administrative construction and thereby to have given it the force of law." Helvering v. R. J. Reynolds Tobacco Co., 306 U.S. 110. This regulation has also been uniformly followed and approved by the Courts.

Applying the above regulation to the facts here, we do not think the properties in question have the same "nature or character," nor are they of the same "kind or class," hence they are not "of a like kind" within the meaning of the statute.

In comparing properties to determine their likeness within the meaning of section 112(b)(1), we must con- [fol. 318] sider not alone the nature and character of the physical properties, but also the nature and character of the title conveyed or the rights of the parties therein. The accepted legal definition of "property" so contemplates and requires. We quote:

> In law it is not the physical, material object alone which constitutes "property." The term means something more than the mere thing which a person owns. * * * [73 C.J.S. 138]

The word "property" means not only the thing possessed, that is the physical corporeal thing, but also rights in the physical, corporeal thing which are created and

sanctioned by law. [73 C.J.S. 140; Texas Co. v. Hauptman, 91 F. 2d 449 and other cases there cited.]

The rights created in the property determine the character of the property owned.

The above cited regulation gives recognition to this legal definition of property. In effect it provides that even if both properties exchanged are realty, if there be substantial difference in the rights created in and to the respective properties, then the properties are not of a like kind. Illustrative of this, it provides that a leasehold interest in land cannot be exchanged for a fee title in land without tax consequences, unless the lease has "thirty years or more [fol. 319] to run."[3] The implication is clear that the rights vested in the respective grantees in and to the properties exchanged must be of the same general character or of substantial equality. If not, then the properties exchanged are not of like kind within the meaning of the Code. It was so held in Midfield Oil Co., 39 B.T.A., 1154, relied upon by respondent, and which sustains his contention here. There it was held that an oil payment limited in amount is different within the meaning of section 112(b)(1) from an overriding royalty which continues as long as production lasts.

The reason there given for holding the properties unlike was because of the "differences in the rights created by the Holmans oil payment and the Dawson overriding royalty," which were held to be "differences of substance and not of mere form." The rights under the Holmans oil payments were to continue only until a specified sum of money was realized therefrom, while the Dawson royalty rights "continued for so long as oil or gas might be produced from the property."

In the instant case the rights created in the overriding royalties or oil payments were almost identical with those created in the Holmans oil payments, the only difference being the amount in dollars and cents to be paid, but in

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[3] This provision of the regulation was discussed and approved in Century Electric Co., 15 T.C. 581, affd. 192 F. 2d 155, certiorari denied, 342 U.S. 954. In Standard Envelope Manufacturing Co., 15 T.C. 41, it was held a lease for 25 years "was not equivalent to a fee."

both, upon completion of payment of the sum specified, the oil interests assigned were to revert to the grantor. Midfield Oil Co., supra, was approved and followed in Kay Kimball, 41 B.T.A. 940.

[fol. 320] Petitioners cite Commissioner v. Crichton, 122 F. 2d 181, affirming Kate J. Crichton, 42 B.T.A. 490, where it was held that an exchange of an undivided interest in oil, gas and other minerals for an undivided fee in a parcel of improved realty was an exchange within the meaning of section 112(b)(1).

That case does not sustain petitioners' contention here. There the mineral interest conveyed was not for a limited period but was an outright and absolute conveyance of the "oil, gas and other minerals in, on and under and that may be produced from" the land therein described. There was no limitation or restriction of any kind. The difference in this respect from the Midfield Oil Co., supra, is pointed out in the Board of Tax Appeals' opinion in the Crichton case, supra. (See 42 B.T.A. at p. 492)

Petitioners rely on Fleming v. Campbell (C.A. 5) 205 F. 2d 549, reversing a U.S.D.C. N.D. Texas case (Sept. 29, 1952). The Appellate Court in its reversal held that an exchange of a limited overriding royalty or oil payment solely for a determinable fee in an oil and gas lease was an exchange of property of like kind within the meaning of section 112(b)(1). Apparently Government counsel there rested their case solely on the ground

" " " that the mineral interest in the Ector County lands was an interest in fee and that in the Gregg County lands, for which it was exchanged, was a leasehold of a fee which does not have thirty or more years to run, and hence that therefore under the regulation the interests exchanged were not of like kind.

[fol. 321] The Court decided the case on the issue as presented and held that both interests exchanged were interests in minerals in place and hence both were interests in land; further, that neither interest was a "leasehold of a fee" in the sense that term is used in the regulation, and therefore the thirty year provision of the regulation did not apply. The issue there is not present in the instant case and the facts here are wholly different.

Here the exchange was not "mineral interests for mineral interests", but an exchange of a fee simple title, an absolute

estate in ranch land for a limited mineral interest which expired when a definite sum of money was realized therefrom.

Notwithstanding the comprehensive terms of conveyance contained in the assignment of the mineral interest, the ceiling limitation therein, whereby the maximumu amount the grantee could ever receive therefrom was a fixed sum of money with interest, stamps the extent of grantee's rights therein more in the nature of a mortgagee than that of owner. The grantee's interest was primarily monetary and of a temporary nature. The grantors at all times owned a residuary title in the mineral property. In any event a temporary title to the oil properties, continuing only until a sum of money is realized therefrom, is not equivalent to an absolute and unconditional title in the ranch land. The rights created were wholly different. The properties here exchanged were not of like kind within the meaning of section 112(b)(1).

Now that we have determined that there was a taxable gain from the exchange, we must ascertain whether it was [fol. 322] ordinary income, as determined by respondent, or capital gain, as contended by petitioners. This question must be decided in favor of the petitioners upon authority of John David Hawn, 23 T. C. 516, Lester A. Nordan, 22 T.C. 1132, and Caldwell v. Campbell, Jr., 218 F. 2d 567, from which this case is not distinguishable in principle. See Walter A. Henshaw, 23 T.C. 176. These cases hold that an oil payment is a capital asset and the gain derived from the sale or exchange of an oil payment may be given capital gains treatment. Similarly, the petitioners' gain from the exchange of the oil payments is entitled to capital gains treatment. Petitioners are sustained on this question.

In arriving at our conclusion that petitioners' gain was a capital gain, we have considered, but cannot sustain, respondent's contention that petitioners' transaction was the mere assignment of future income in exchange for a ranch.

Issue II

On October 5, 1949, C. C. Cross conveyed to F. Howard Walsh the fee simple title to certain urban real estate in Fort Worth, Texas. As the sole consideration for this land, F. Howard Walsh conveyed to Cross certain limited

overriding royalties or oil payment interest." Walsh's conveyance to Cross was in part as follows:

" " " F. Howard Walsh, does hereby, subject to the conditions and limitations hereinafter set out, bargain, sell, assign and convey unto C. C. Cross, of Tarrant County, Texas, his heirs and assigns, the following described over-[fol. 323] riding royalty and mineral interests carved out of the interests owned by the undersigned grantor in and to the oil and gas leases and leasehold estates, insofar as they cover the tracts of land and leases described above,—such interests herein conveyed being the following fractional parts of the oil, in, under, or upon, or that may be produced from such tracts of land under the terms of said leases, to-wit:

(a) 1/4 of 7/8 of such oil, insofar as all of the tracts and leases in Ward County above described are concerned, save and except Walsh's "Killough" Lease; and

(b) 1/4 of 7/16 of such oil, insofar as such Killough Lease is concerned.

This grant is made subject to the following conditions and limitations, to-wit:

. . . . . .

(c) When and if Cross, or his heirs and assigns, shall have received, under the terms of said conveyance and assignment, oil of the net value of Sixty-Five Thousand and No/100 Dollars ($65,000.00), plus interest at the rate of seven (7) per cent per annum on the balances unpaid from time to time (exclusive of gross production taxes, which may be deducted from Cross's part of the oil),—then Cross shall have no further interest in said oil and gas leases or leasehold estate, and the oil then remaining in, under or upon said tracts of land, or thereafter produced therefrom; and the interests hereby conveyed shall automatically revert to Walsh his heirs and assigns.

[fol. 324] Corss's share of the oil produced from the property named in the conveyance, from the effective date of the conveyance to the close of 1952, amounted to:

Year	Amount
1949	$ 3,909.61
1950	22,391.12
1951	22,673.03
1952	21,793.90

On their 1949 income tax return F. Howard Walsh and his wife treated this transaction as an exchange of property of like kind under section 112(b)(1). Respondent determined that the transaction produced ordinary depletable income for them. Respondent also determined that the real estate acquired by Walsh had a market value of $65,000, that the limited overriding royalties or oil payment interest had no basis in Walsh's hands, and that the allowance for depletion was $17,875, with a net income of $47,125 taxable to Walsh and his wife in 1949.

The exchange by F. Howard Walsh of an oil payment out of oil and gas leases situated in Ward County, Texas, for fee simple title to revenue producing real estate situated in Fort Worth, Tarrant County, Texas, was not an exchange of property for property of a like kind and the gain derived therefrom is taxable income.

In this issue petitioners F. Howard Walsh and Mary D. Walsh conveyed an oil payment to C. C. Cross for a piece of urban real property. There is no real difference between this exchange and that we discussed in the first issue. [fol. 325] Therefore, for the reasons stated in the first issue, petitioners' gain in this issue is taxed like the gain considered in the first issue.

[fol. 326] Decision will be entered under Rule 50.

IN THE TAX COURT OF THE UNITED STATES

Docket No. 46713

WM. FLEMING and BESSIE M. FLEMING, Husband and Wife, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

DECISION—Entered September 28, 1955

Pursuant to Opinion of the Tax Court filed July 29, 1955, respondent filed a computation on September 27, 1955, in which petitioners concurred. Now, therefore, it is

Ordered and Decided: That there is a deficiency in income tax for the calendar year 1948 in the amount of $43,813.48.

(Signed) Luther A. Johnson, Judge.

[fol. 327] In the Tax Court of the United States

Docket No. 46781

F. Howard Walsh and Mary D. Walsh, Husband and Wife, Petitioner,

v.

Commissioner of Internal Revenue, Respondent

Decision—Entered September 28, 1955

Pursuant to Opinion of the Tax Court filed July 29, 1955, respondent filed a computation on September 27, 1955, in which petitioners concurred. Now, therefore, it is

Ordered and Decided: That there are deficiencies in income tax for the calendar years 1948 and 1949 in the respective amounts of $2,217.94 and $18,896.79.

(Signed) Luther A. Johnson, Judge.

In the Tax Court of the United States

Docket No. 46782

Mary D. Fleming Walsh, Petitioner

v.

Commissioner of Internal Revenue, Respondent

Decision—Entered September 28, 1955

Pursuant to Opinion of the Tax Court filed July 29, 1955, respondent filed a computation on September 27, 1955, in [fol. 328] which petitioner concurred. Now, therefore, it is

Ordered and Decided: That there are deficiencies in income tax for the fiscal year ended August 31, 1948 and the fiscal year ended August 31, 1949, in the respective amounts of $23,889.26 and $16,145.41.

(Signed) Luther A. Johnson, Judge.

In the Tax Court of the United States

Docket No. 46713

Wm. Fleming and Bessie M. Fleming, husband and wife, Petitioners,

v.

Commissioner of Internal Revenue, Respondent

Docket No. 46781

F. Howard Walsh and Mary D. Walsh, husband and wife, Petitioners,

v.

Commissioner of Internal Revenue, Respondent

Docket No. 46782

Mary D. Fleming Walsh, Petitioner

v.

Commissioner of Internal Revenue, Respondent

Stipulation for Consolidation on Petition for Review—Filed Dec. 1, 1955

The petitioners above named and the Commissioner of Internal Revenue, each acting by and through their respec- [fol. 329] tive attorneys of record, hereby agree and stipulate as follows:

The above-styled and numbered causes shall be, and they are hereby, consolidated for the purpose of review by the United States Court of Appeals for the Fifth Circuit of

the decisions heretofore entered by The Tax Court of The United States in said causes; said review being taken at the instance of the petitioners. In all of the proceedings which the petitioners may take to obtain a review of said decisions, they may proceed as if there was only one cause and join said causes in one Petition for Review, and present to The United States Court of Appeals for the Fifth Circuit only one Petition for Review and only one record, which shall embrace all of the pertinent proceedings had in said consolidated causes.

In the event the Respondent should determine to file a Petition for Review of said decisions, he, likewise, may proceed as if there were only one cause and join said causes in one Cross Petition for Review and present to The United States Court of Appeals only one Cross Petition for Review and only one record, which shall embrace all of the pertinent proceedings had in said consolidated causes.

This agreement and stipulation are entered into because said proceedings were consolidated for hearing and decision before The Tax Court of The United States, and because in several respects said causes involved the same transactions and most of the evidence and proceedings in one of said causes are equally applicable to and pertinent to the other, and because they were disposed of by The Tax Court of The United States in one opinion.

[fol. 330] Executed upon behalf of the above named parties by their respective attorneys of record this 1st day of November, 1955.

Harry C. Weeks, Attorney for Petitioners, John Potts Barnes, Jr., Attorney for Respondent. (Signed) John Potts Barnes, CAR.

IN THE TAX COURT OF THE UNITED STATES

Docket No. 46713

WM. FLEMING and BESSIE M. FLEMING, Husband and Wife, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 46781

F. HOWARD WALSH and MARY D. WALSH, Husband and Wife, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 46782

MARY D. FLEMING WALSH, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

STIPULATION — Filed Jan. 13, 1954

The parties to the above styled and numbered causes, and each of them, acting herein by and through their respective attorneys of record, hereby agree and stipulate as follows:

[fol. 331] 1

These proceedings shall be consolidated for hearing and decision, and shall be removed from the Dallas, Texas Calendar of The Tax Court of The United States, and shall be submitted to The Tax Court of The United States at Washington, D. C. under and in accordance with Rule 30 of the Rules of Practice Before The Tax Court of The United States.

2

Upon submission of these causes, in accordance with the foregoing paragraph, the facts herein set forth shall be accepted as true and, with the admissions of fact made in the pleadings filed in these causes, shall constitute the evidence upon which these causes are submitted.

3

At all times pertinent to these proceedings, Wm. Fleming and Bessie M. Fleming, the Petitioners in Cause No. 46713, were husband and wife residing together in Fort Worth, Texas. Likewise, F. Howard Walsh and Mary D. Walsh, the Petitioners in said Cause No. 46781, were at all such pertinent times husband and wife residing together in Fort Worth, Texas. Mary D. Fleming Walsh, the Petitioner in said Cause No. 46782, is the same person as Mary D. Walsh, one of the Petitioners in Cause No. 46781, and is the daughter of Wm. Fleming, one of the Petitioners in Docket No. 46713.

4

Throughout each and all of the years involved in each and all of these proceedings, there existed a private trust [fol. 332] known as "Wm. Fleming, Trustee", of which the aforesaid Wm. Fleming was the sole Trustee and Mary D. Fleming Walsh was the sole beneficiary. This Trust had been created in 1931, and it continued in existence until on or about November 30, 1950, when it was terminated in accordance with its terms, and all assets of every kind and description belonging to the Trust were transferred and conveyed to the said beneficiary, Mary D. Fleming Walsh. Said Trust kept its books and records upon the cash receipts and disbursement basis and for fiscal year periods ending on August 31 of each year. Throughout its existence said Trust filed income tax returns with the Collector of Internal Revenue for the Second Collection District of Texas at Dallas, Texas. This Trust is the same trust which was the Appellant in Wm. Fleming, Trustee, v. Commissioner of Internal Revenue, 121 F. 2d 7, affirming 43 B T A 229, and the allocation for deductions of depreciation and depletion between said Trust and its beneficiary

are to be made in accordance with the rules laid down in said opinions.

5

During all of the times involved in these proceedings, and each of them, Wm. Fleming and Mr. Fleming, Trustee were engaged in business as partners under the name and style of "Fleming Oil Company"; the partnership business being primarily that of producing oil and gas, and, secondarily, of making investments. During such times, the interest of the said Wm. Fleming in said partnership was 61.026 per cent, and of Wm. Fleming, Trustee 38.974 per cent. Said partnership kept its books and records and made its income tax returns upon the cash receipt and dis- [fol. 333] bursement basis and for calendar year periods. The tax returns of said partnership were filed with the Collector of Internal Revenue for the Second Collection District of Texas at Dallas, Texas.

6

Wm. Fleming and wife, Bessie M. Fleming, kept their books and records and made their income tax returns upon the cash receipt and disbursement basis and for calendar year periods. They filed a joint return for the year 1948. Petitioners, F. Howard Walsh and Mary D. Walsh, kept their books and records and made their income tax returns upon the cash receipt and disbursement basis and for calendar year periods. They filed joint income tax returns for the years 1948 and 1949. All the tax returns referred to in this paragraph were filed in the office of the Collector of Internal Revenue for the Second Collection District of Texas at Dallas, Texas.

7

On May 19, 1948, in accordance with a pre-existing agreement so to do, an exchange was consummated between Fleming Oil Company, Wm. Fleming, Trustee and Wm. Fleming, on the one hand, and Marie Hildreth Cline on the other, by which Fleming Oil Company, Wm. Fleming, Trustee and Wm. Fleming were conveyed by the said Marie Hildreth Cline (joined by her husband), in the proportion of an undivided fifty per cent (50%) to Fleming Oil Company, and an undivided twenty five per cent (25%) to Wm.

Fleming, Trustee, and a like undivided twenty five per cent (25%) to Wm. Fleming, the fee simple title to some [fol. 334] 2,994.5 acres of land situated in Parker and Tarrant Counties, Texas, then used and suitable for ranching purposes. As the sole consideration for said conveyance, Fleming Oil Company, Wm. Fleming, Trustee and Wm. Fleming assigned and conveyed to the said Marie Hildreth Cline the limited overriding royalty or oil payment interests herein more fully described. These limited overriding royalty or oil payment interests came from oil and gas leases, or oil and gas mineral interests, which the respective transferors had held and owned for considerably more than six (6) months prior to the date of said transaction—May 19, 1948,—for productive use in their respective trades and businesses and not for sale. The said ranch so acquired in said exchange by Fleming Oil Company, Wm. Fleming, Trustee and Wm. Fleming, was acquired by them, and each of them, for investment, and has been held for investment, and not for sale, since said acquisition.

8

The limited overriding loyalty or oil payment interests conveyed by Fleming Oil Company to Marie Hildreth Cline, as aforesaid, were conveyed by an instrument, a copy of which is attached hereto, marked Exhibit A for identification, and hereof made a part for all purposes. The O. L. Denman "C", the O. L. Denman "H" Leases, the C. D. Read "A" and "B" Leases, and the D. H. Snyder Lease referred to in said Exhibit A were ordinary commercial oil and gas leases on lands in Texas, and each of them was then producing oil and gas. The fair market value and selling price of the share of the oil produced from said properties, from and after the effective date of the [fol. 335] assignment to Marie Hildreth Cline to the close of the year 1952, applicable to the interest so conveyed to her, were:

1948	$15,801.16
1949	22,835.94
1950	31,172.41
1951	31,350.19
1952	30,559.54

9

The limited overriding royalty *royalty* or oil payment interest conveyed by Wm. Fleming to Marie Hildreth Cline, as aforesaid, was conveyed by an instrument, a copy of which is attached thereto, marked Exhibit B. for identification, and hereof made a part for all purposes. The L. H. Choate Lease, referred to in said Exhibit B, was an ordinary commercial oil and gas lease on lands in Eddy County, New Mexico, and was then producing oil and gas. The fair market value and selling price of the share of the oil produced from said property, from and after the effective date of the assignment to Marie Hildreth Cline to the close of the year 1952, applicable to the interest so conveyed to her, were:

1948	$5,423.49
1949	9,412.84
1950	7,916.69
1951	4,854.74
1952	6,420.78

[fol. 336] 10

One of the limited overriding royalty or oil payment interests conveyed by Wm. Fleming, Trustee to Marie Hildreth Cline, as aforesaid, was conveyed by an instrument, a copy of which is attached hereto, marked Exhibit C for identification, and hereof made a part for all purposes. The J. M. Christian lease, referred to in said Exhibit C, was an ordinary commercial oil and gas lease on lands in Gregg County, Texas, which was then producing oil and gas. The fair market value and selling price of the share of the oil produced from said property, from and after the effective date of the assignment to Marie Hildreth Cline to the close of the year 1952, applicable to the interest so conveyed to her, were:

1948	$4,436.99
1949	7,365.73
1950	7,423.68
1951	7,793.11
1952	7,730.24

The other limited overriding royalty or oil payment interest conveyed by Wm. Fleming, Trustee to Marie Hildreth Cline was conveyed by an instrument, a copy of which is attached hereto, marked Exhibit D for identification, and hereof made a part for all purposes. The interest so conveyed came from a mineral interest in Cooke County, Texas, then owned in fee by Wm. Fleming, Trustee, and which lands were then producing oil and gas. The fair market value and selling price of the share of the oil produced from said property, from and after the effective date of the assignment to Marie Hildreth Cline to the close of the year [fol. 337] 1952, applicable to the interest so conveyed to her, were:

1948	$2,306.57
1949	3,393.20
1950	3,913.38
1951	3,985.71
1952	3,248.27

11

In their respective tax returns for the appropriate periods, the calendar year 1948 for Wm. Fleming and wife, Bessie M. Fleming, and for the partnership Fleming Oil Company, and as to Wm. Fleming, Trustee, for the fiscal year ended August 31, 1948 the exchange between the said Marie Hildreth Cline on the one hand, and Wm. Fleming, Wm. Fleming Trustee, and Fleming Oil Company on the other, was treated as an exchange of properties of like kind under Section 112(b)(1) of the Internal Revenue Code. But in making the final determinations of the income of Wm. Fleming and wife, Bessie M. Fleming, Fleming Oil Company and Wm. Fleming Trustee, the respondent held and determined that each of said exchanges produced ordinary income from the respective properties out of which the various interests conveyed by them came, and that the respective assignors were entitled to allowances for depletion computed under Section 114(b)(3) of the Internal Revenue Code, with respect to such gross income, and further made the related determinations set forth in the following tabulation:

[fol. 338]

	Fleming Oil Co.	Wm. Fleming	Wm. Fleming Trustee
Fair market value of interest in Cline Ranch received	$147,000.00	$73,500.00	$73,500.00
Net cost or basis of property transferred by	1,102.70	None	18,119.21
Percentage Depletion allowable to	40,425.00	20,212.50	20,212.50
Net income from exchange received by	106,575.00	53,287.50	53,287.50

Accordingly, in determining the deficiencies and transferee liabilities here involved, the respondent, on account of said Cline exchange, added $106,575 to the income of said Fleming Oil Company for 1948 as otherwise determined by him; and on this account increased the net income of Wm. Fleming and wife, Bessie M. Fleming, as otherwise determined by him, by 61.026 per cent thereof as their distributive share of said partnership earnings for 1948; and further increased their said income for said year by $53,287.50, on account of that portion of the said exchange directly between said Wm. Fleming and said Marie Hildreth Cline. Further, in determining the income of Wm. Fleming, Trustee for its fiscal year ended August 31, 1948, respondent added to the income, as otherwise determined by him for that period, $53,287.50, on account of that portion of said exchange directly between Wm. Fleming, Trustee, and Marie Hildreth Cline; and, in his determination of the income of Wm. Fleming, Trustee, for its fiscal year ended August 31, 1949, added 38.974 per cent of $106,575 to said Trust's distributive share of the profits of the partnership, Fleming Oil Company for 1948, as otherwise determined [fol. 339] by him. Further, respondent determined that said Trust distributed to its beneficiary, Mary D. Walsh, $10,000 during its fiscal year ended August 31, 1948, and $27,000 during its fiscal year ended August 31, 1949.

12

On October 5, 1949, in accordance with an existing agreement so to do, one C. C. Cross conveyed to petitioner F. Howard Walsh, the fee simple title to revenue-producing business real estate located in Fort Worth, Tarrant County, Texas, and, as the sole consideration for this conveyance, F. Howard Walsh conveyed to said C. C. Cross limited overriding royalty or oil-payment interests out of various ordinary commercial oil and gas leases on lands in Texas

which were then producing oil and gas, and which the said F. Howard Walsh had then owned and held for much more than six (6) months for productive use in his business of producing oil, and not for sale. The real estate so acquired by the said Walsh in Fort Worth, Texas, was acquired by him for investment and not for sale. The limited overiding royalty or oil-payment interests conveyed by F. Howard Walsh to the said C. C. Cross were conveyed by an instrument a copy of which is attached hereto, marked Exhibit E and made a part hereof for all purposes. This transaction was treated by the said Walsh and wife in their said 1949 income tax return as exchange of properties of like kind under Section 112(b)(1) of the Internal Revenue Code, but respondent, in determining the deficiency asserted against them for 1949, determined that said transaction produced ordinary depletable income taxable to them for 1949, just as he had done with respect [fol. 340] to the Fleming, et al.—Cline exchange heretofore dealt with, and for the same reasons. As to the Walsh—Cross Exchange, respondent determined that the Fort Worth real estate so received by Walsh then had a market value of $65,000, that the limited overriding royalties or oil payments transferred to Cross by Walsh had no net cost or basis in Walsh's hands and Walsh was entitled to an allowance for depletion with respect to said $65,000 of $17,875, leaving $47,125 net income from the transaction taxable to Walsh and wife for 1949. The fair market value and selling price of the share of the oil produced from said property and applicable to the interests so conveyed by Exhibit E to Cross from and after the effective date of said conveyance to the close of the year 1952 were:

1949	$ 3,909.61
1950	22,391.12
1951	22,673.03
1952	21,793.90

[fol. 341] 15

Mary D. Fleming Walsh, the petitioner in docket No. 46782, stipulates and admits that she is liable as a transferee for whatever deficiency in income tax may be finally found to be due by Wm. Fleming Trustee for the taxable

periods of Wm. Fleming Trustee involved in said docket No. 46782.

In Witness Whereof, this stipulation has been executed in several counterparts upon behalf of the respective parties by their respective attorneys of record, this 8th day of December, 1953.

Harry C. Weeks, Attorney of Record for all Petitioners. (Signed) Daniel A. Taylor, ATA, Attorney for Respondent.

[fol. 342] EXHIBIT A TO STIPULATION

Assignment of Oil Payment From Fleming Oil Company to Mrs. Marie Hildreth Cline

STATE OF TEXAS,
County of Howard:

Whereas, as shown by the records of Howard County, Texas, Fleming Oil Company, a partnership composed of Wm. Fleming, individually, as trustee, and as independent executor of the estate of Anna Maud Fleming, deceased, is the owner of one-half (1/2) of the seven-eighths (7/8) oil and gas leasehold estate covering the following described tracts of land in Howard County, Texas, to-wit:

(Stamps)

First Tract: North half of South half, Section 16, Block 30, Township 1 South, T. & P. Ry. Co. Survey, covered by oil and gas lease dated November 14, 1939, between Mrs. Ollie L. Denman, a widow, lessor, and Fleming-Kimbell Corporation, lessee, recorded in Vol. 106, Page 119, Deed Records, Howard County, Texas. (Known as O. L. Denman "C" Lease).

Second Tract: Northwest quarter of Section 10, Block 30, Township 1 South, T. & P. Ry. Co. Survey, covered by oil and gas lease dated September 21, 1928, executed by L. C. Denman and wife, Ollie Denman, lessors, and Empire Gas & Fuel Company, lessee, and recorded in Vol. 72, Page 336, Deed Records, Howard County, Texas. (Known as O. L. Denman "H" Lease).

[fol. 343] Third Tract: Southeast quarter and West half of Southwest quarter, Section 46, Block 30, Township 1 North, T. & P. Ry. Co. Survey, the oil and gas lease covering same being described in two assignments from the Iron Mountain Oil Company to F. H. E. Oil Company et al., dated April 7, 1941, and recorded in Vol. 109, Page 314, and Vol. 109, Page 315, Deed Records, Howard County, Texas, respectively. (Known as C. D. Read "A" and "B" Leases).

Fourth Tract: South half of Southeast quarter, Section 28, Block 30, Township 1 South, T. & P. Ry. Co. Survey, the oil and gas lease covering same being described in assignment from Iron Mountain Oil Company to F. H. E. Oil Company et al., dated April 4, 1941, and recorded in Vol. 109, Page 316, Deed Records, Howard County, Texas. (Known as D. H. Snyder "C" Lease).

Now, Therefore, in consideration of the sum of Ten Dollars ($10.00) cash and other good and valuable considerations to it in hand paid by Mrs. Marie Hildreth Cline, wife of G. L. Cline, out of her separate property and estate, the receipt of which is hereby acknowledged, the undersigned, Fleming Oil Company, a partnership as aforesaid, does hereby sell, assign, and convey unto the said Mrs. Marie Hildreth Cline, as a part of her separate property and estate, her heirs and assigns, the following described real property, to-wit:

An overriding royalty and mineral interest carved hereby out of the interest owned by Fleming Oil Company in each and all of the oil and gas leases described above, amount-[fol. 344] ing to an undivided 49/128ths interest in and to all the oil in, under, and that may be produced, saved and marketed from the above described tracts of land under the terms of the oil and gas leases covering same, until the grantee named above shall have received therefrom oil of the net value of One Hundred Forty-seven Thousand Dollars ($147,000.00), plus an amount equal to five per cent (5%) interest per annum from May 19, 1948, on the portions of said $147,000.00 which may be unsatisfied from time to time.

This grant is made subject to the following conditions, limitations, and agreements:

(1) No interest in the gas or casinghead gas in, under, or produced and saved from said tracts, and no interest in

the personal property now or hereafter placed thereon is assigned or conveyed to grantee, this conveyance affecting the oil only.

(2) Grantee, her heirs and assigns, shall be entitled to receive the net sum of $147,000.00, plus an amount equal to five per cent (5%) interest as above provided, from the fractional part of the oil hereby conveyed, exclusive of, and in addition, to any gross production or severance taxes which may be deducted from grantee's part of the proceeds.

(3) This conveyance shall become effective as of seven o'clock, A. M., on the 1st day of June, 1948, and covers and includes 49/128ths of all oil in, under, and sold and marketed from the tracts above described, from and after said date and hour.

(4) All of the development and operating costs and expenses incurred in connection with said oil and gas leases [fol. 345] shall, as between the parties hereto, be borne exclusively by grantor, the fractional interest hereby conveyed to grantee being free and clear of all costs of development and operation.

(5) When and if the grantee herein, her heirs and assigns, have received from the fractional interest hereby assigned, oil of the net value of $147,000.00, plus an amount equal to five per cent (5%) interest as above provided, then the interest hereby conveyed to said grantee shall cease and terminate, and said interest shall revert to, and shall thereafter be owned by grantor, its successors, heirs or assigns; and grantee, her heirs and assigns, shall have no further interest in said oil and gas leasehold estates covering said land, or in the oil thereunder; and grantee, her heirs or assigns, shall, upon request, execute such instruments as may be necessary or proper to evidence this of record.

(6) The execution of this conveyance shall not impose upon grantor any obligation with respect to developing or operating the property covered hereby, nor shall it be implied herefrom that grantor is in anywise obligated to see that grantee receives oil aggregating the net value of $147,000.00, plus an amount equal to five per cent (5%) interest as above provided, or any lesser sum; but grantor does covenant and agree that grantee shall have the same but no greater right to require grantor to develop and operate said property in accordance with the terms of the

original leases upon said property as the original lessors therein, their heirs or assigns, might have or exercise.
[fol. 346] And, for the same consideration, the undersigned grantor, for itself and its successors, does hereby agree to warrant and forever defend the title to the interest herein granted to said grantee, her heirs and assigns, against the lawful claims and demands of all persons, whomsoever.

Dated this 19th day of May, A. D. 1948.

Fleming Oil Company, by Wm. Fleming, Individually, as Trustee, and as Independent Executor of the Estate of Anna Maud Fleming, Deceased.

EXHIBIT B TO STIPULATION

Assignment of Oil Payment from Wm. Fleming to Mrs. Marie Hildreth Cline

STATE OF NEW MEXICO,
County of Eddy:

Whereas the undersigned grantor, Wm. Fleming, is the owner of an undivided interest in certain oil and gas leases covering the following described land in Eddy County, New Mexico, to-wit:

The Southwest Quarter (SW ¼); the West one-half of the Southeast one-fourth (W ½ SE ¼); the Northeast one-fourth of the Southeast one-fourth (NE ¼ SE ¼); and Southwest one-fourth of the Northwest one-fourth (SW ¼ NW ¼), all in Section 2, Township 17 South, Range 30 East, N. M. P. M.;
[fol. 347] the oil and gas leases covering same being described in an assignment from L. H. Choate and wife, Lucille Choate, to Wm. Fleming, dated November 8, 1943, and recorded in Book 22, Page 139, Oil and Gas Records, Eddy County, New Mexico;

Now, Therefore, in consideration of the sum of Ten Dollars ($10.00) and other good and valuable considerations to him in hand paid by Mrs. Marie Hildreth Cline, the wife of G. L. Cline, out of her separate property and estate, the

receipt of which is hereby acknowledged, said Wm. Fleming does hereby sell, assign, and convey unto the said Mrs. Marie Hildreth Cline, as a part of her separate property and estate, and to her heirs and assigns, the following described real property, to-wit:

An overriding royalty and mineral interest carved hereby out of the interest owned by Wm. Fleming in each and all of the oil and gas leases described above, amounting to a .166668 interest in and to all the oil in, under, and that may be produced, saved and marketed from the above described tracts of land under the terms of the oil and gas leases covering same, until the grantee named above shall have received therefrom oil of the net value of Seventy three Thousand Five Hundred Dollars ($73,500.00), plus an amount equal to five per cent (5%) interest per annum from May 19, 1948, on the portions of said $73,500.00 which may be unsatisfied from time to time.

This grant is made subject to the following conditions, limitations, and agreements:

(1) No interest in the gas or casinghead gas in, under, or produced and saved from said tracks, and no interest [fol. 348] in the personal property now or hereafter placed thereon is assigned or conveyed to grantee, this conveyance affecting the oil only.

(2) Grantee, her heirs and assigns, shall be entitled to receive the net sum of $73,500.00, plus an amount equal to five per cent (5%) interest as above provided, from the fractional part of the oil hereby conveyed, exclusive of, and in addition, to any gross production or severance taxes which may be deducted from grantee's part of the proceeds.

(3) This conveyance shall become effective as of seven o'clock, A. M., on the 1st day of June, 1948, and covers and includes .166668 of all oil in, under, and sold and marketed from the tracts above described, from and after said date and hour.

(4) All of the development and operating costs and expenses incurred in connection with said oil and gas leases shall, as between the parties hereto, be borne exclusively by grantor, the fractional interest hereby conveyed to grantee being free and clear of all costs of development and operation.

(5) When and if the grantee herein, her heirs and assigns, have received from the fractional interest hereby assigned, oil of the net value of $73,500.00, plus an amount equal to five per cent (5%) interest as above provided, then the interest hereby conveyed to said grantee shall cease and terminate, and said interest shall revert to, and shall thereafter be owned by grantor, his heirs or assigns; and grantee, her heirs and assigns, shall have no further interest in said oil and gas leasehold estates covering said [fol. 349] land, or in the oil thereunder; and grantee, her heirs or assigns, shall, upon request, execute such instruments as may be necessary or proper to evidence this of record.

(6) The execution of this conveyance shall not impose upon grantor any obligation with respect to developing or operating the property covered hereby, nor shall it be implied herefrom that grantor is in anywise obligated to see that grantee receives oil aggregating the net value of $73,500.00, plus an amount equal to five per cent (5%) interest as above provided, or any lesser sum; but grantor does covenant and agree that grantee shall have the same but no greater right to require grantor to develop and operate said property in accordance with the terms of the original leases upon said property as the original lessors therein, their heirs or assigns, might have or exercise.

And, for the same consideration, the undersigned grantor, for himself, his heirs and assigns, does hereby agree to warrant and forever defend the title to the interest herein granted to said grantee, her heirs and assigns, against the lawful claims and demands of all persons, whomsoever.

Dated this 19th day of May, A. D. 1948.

Wm. Fleming.

[fol. 350] EXHIBIT C TO STIPULATION

Assignment of Oil Payment from Wm. Fleming, Trustee, to Mrs. Marie Hildreth Cline.

STATE OF TEXAS,
County of Gregg:

Whereas, the undersigned grantor, Wm. Fleming, Trustee, as shown by the records of Gregg County, Texas, is the owner of an undivided interest in certain oil and gas

leases covering the following described tract of land in Gregg County, Texas, to-wit:

Forty-two and three-fourths (42¾) acres out of the G. W. Hooper Survey,

as described in that certain assignment dated Dec. 15, 1933, executed by E. J. Koenig to Wm. Fleming, Trustee, which assignment is of record in Vol. 156, Page 98, Deed Records of Gregg County, Texas. (Said tract is known as the J. M. Christian Lease).

Now, Therefore, in consideration of the sum of Ten Dollars ($10.00) and other good and valuable considerations to him in hand paid by Mrs. Marie Hildreth Cline, the wife of G. L. Cline, out of her separate property and estate, the receipt of which is hereby acknowledged, said Wm. Fleming does hereby sell, assign, and convey unto the said Mrs. Marie Hildreth Cline, as a part of her separate property and estate, and to her heirs and assigns, the following described real property, to-wit:

An overriding royalty and mineral interest carved hereby [fol. 351] out of the interest owned by Wm. Fleming, Trustee, in each and all of the oil and gas leases described above, amounting to an undivided 6/100ths interest in and to 7/8ths of all the oil in, under, and that may be produced, saved and marketed from the above described tract of land under the terms of the oil and gas leases covering same, until the grantee named above shall have received therefrom (in oil) of the net value of Forty-nine Thousand Dollars ($49,000.00), plus an amount equal to five per cent (5%) interest per annum from May 19, 1948, on the portions of said $49,000.00 which may be unsatisfied from time to time.

This grant is made subject to the following conditions, limitations, and agreements:

(1) No interest in the gas or casinghead gas in, under, or produced and saved from said tract, and no interest in the personal property now or hereafter placed therein is assigned or conveyed to grantee, this conveyance affecting the oil only.

(2) Grantee, her heirs and assigns, shall be entitled to receive the net sum of $49,000.00, plus an amount equal to five per cent (5%) interest as above provided, from the fractional part of the oil hereby conveyed, exclusive of, and in addition, to any gross production or severance taxes which may be deducted from grantee's part of the proceeds.

(3) This conveyance shall become effective as of seven o'clock, A.M., on the 1st day of June, 1948, and covers and includes 6 100ths of 7sths of all oil in, under, and sold and marketed from the tract above described, from and after said date and hour.

[fol. 352] (4) All of the development and operating costs and expenses incurred in connection with said oil and gas leases shall, as between the parties hereto, be borne exclusively by grantor, the fractional interest hereby conveyed to grantee being free and clear of all costs of development and operation.

(5) When and if the grantee herein, her heirs and assigns, have received from the fractional interest hereby assigned, oil of the net value of $49,000.00, plus an amount equal to five per cent (5%) interest as above provided, then the interest hereby conveyed to said grantee shall cease and terminate, and said interest shall revert to, and shall thereafter be owned by grantor, his heirs or assigns; and grantee, her heirs and assigns, shall have no further interest in said oil and gas leasehold estates covering said land, or in the oil thereunder; and grantee, her heirs or assigns, shall, upon request, execute such instruments as may be necessary or proper to evidence this of record.

(6) The execution of this conveyance shall not impose upon grantor any obligation with respect to developing or operating the property covered hereby, nor shall it be implied herefrom that grantor is in anywise obligated to see that grantee receives oil aggregating the net value of $49,000.00, plus an amount equal to five per cent (5%) interest as above provided, or any lesser sum; but grantor does covenant and agree that grantee shall have the same but no greater right to require grantor to develop and operate said property in accordance with the terms of the original leases upon said property as the original lessors therein, their heirs or assigns, might have or exercise.

[fol. 353] And, for the same consideration, the undersigned grantor, for himself, his heirs, successors, and assigns, does hereby agree to warrant and forever defend the title to the interest herein granted to said granted, her heirs and assigns, against the lawful claims and demands of all persons, whomsoever.

Dated this 19th day of May, A. D. 1948

Wm. Fleming, Trustee.

EXHIBIT D TO STIPULATION

Mineral Deed

From Wm. Fleming, Trustee, To Mrs. Marie Hildreth Cline.

STATE OF TEXAS,
County of Cooke:

Know All Men By These Presents:

That Wm. Fleming, Trustee, of Tarrant County, Texas, for and in consideration of Ten Dollars ($10.00) and other good and valuable considerations to him in hand paid out of her separate property and estate by Mrs. Marie Hildreth Cline, wife of G. L. Cline, hereinafter called grantee, the receipt of which is hereby acknowledged, does, subject to the conditions and limitations set forth below, grant, sell, and convey unto the said grantee, as a part of her separate property and estate, an undivided 32.3535/400ths royalty interest in and to all of the oil in, under, and that may be produced from the following described land situated in Cooke County, Texas, to-wit:

[fol. 354] The East 400 acres of the West 700 acres of a 973.7 acre tract out of the Conrad Furnash Survey, which 973.7 acres are described by metes and bounds in that certain mineral deed dated October 10, 1946, executed by B. V. Whitfield to Wm. Fleming, Trustee, which deed is of record in Vol. 315, Page 287, Deed Records, Cooke County, Texas;

Said land being now under an oil and gas lease, it is understood and agreed that this sale is made subject to the terms of said lease, but covers and includes 32.3535/400ths

of the 1/8th royalty on oil due and to be paid under the terms of said lease, insofar as it covers the above described land, until the grantee named above shall have received oil of the net value of Twenty-four Thousand Five Hundred Dollars ($24,500.00), plus an amount equal to five per cent (5%) interest per annum from May 19, 1948, on the portions of said $24,500.00 which may be unsatisfied from time to time.

This grant is made subject to the following conditions, limitations, and agreements:

(1) No interest in the gas or casinghead gas in, under, or produced and saved from said tracts is assigned or conveyed to grantee, this conveyance affecting the oil only.

(2) Grantee, her heirs and assigns, shall be entitled to receive the net sum of $24,500.00, plus an amount equal to five per cent (5%) interest as above provided, from the fractional part of the oil hereby conveyed, exclusive of, and in addition, to any gross production or severance taxes which may be deducted from grantee's part of the proceeds.

[fol. 355] (3) This conveyance shall become effective as of seven o'clock, A. M., on the 1st day of June, 1948, and covers and includes 32.3535 400ths of 1/8th of all oil in, under, and sold and marketed from the tract above described, from and after said date and hour.

(4) When and if the grantee herein, her heirs and assigns, have received from the fractional interest hereby conveyed, oil of the net value of $24,500.00, plus an amount equal to five per cent (5%) interest per annum as above provided, then the interest hereby conveyed to said grantee shall cease and terminate, and said interest shall revert to, and shall thereafter be owned by grantor, his heirs, successors and assigns; and grantee, her heirs and assigns shall have no further interest in said oil in, under, or that may be produced from said land; and grantee, her heirs and assigns, shall, upon request, execute such instruments as may be necessary or proper to evidence this of record.

And, for the same consideration, the undersigned grantor, for himself, his heirs, successors and assigns, does hereby agree to warrant and forever defend the title to the interest herein granted to said grantee, her heirs and assigns,

against the lawful claims and demands of all persons, whomsoever.

Dated this 19th day of May, A. D., 1948.

Wm. Fleming, Trustee.

[fol. 356] EXHIBIT F TO STIPULATION

Conveyance From F. Howard Walsh To C. C. Cross.

THE STATE OF TEXAS,
County of Ward:

Know All Men By These Presents:

Whereas the undersigned grantor, F. Howard Walsh, is the owner, as shown by the records of Ward County, of all or an undivided interest in the oil and gas leasehold estates covering the following described tracts and oil and gas leases located in Ward County, Texas, to-wit:

(a) Walsh's "Killough" Lease, covering all of the NE 2 of the N 4 of Sec. 29, Blk. B-29, Public School Land, more particularly described in assignment from Atlantic Oil Producing Company to F. H. E. Oil Company, dated April 10, 1936, and recorded in Vol. 66, Page 396, Deed Records of Ward County, Texas;

(b) Walsh's "Richter A" Lease, "Richter B" Lease, and "Richter C" Lease, covering four 20-acre tracts described in that certain assignment from F. Howard Walsh to Broadway Baptist Church, dated June 11, 1948, and of record in Vol. 120, Pages 85-7, Assignment Records of Ward County, Texas;

(c) Walsh's "Green" Lease, being the W/4 of the N/4 and the N/4 of the W/4 and the NW 10 acres of the S/4 of the N/4 of Sec. 29, Block B-29, Public School Land, being the tracts described in the assignment from F. H. E. Oil Company to F. Howard Walsh, dated October 4, 1940, and recorded in Vol. 89, Page 433, Assignment Records of Ward County.

[fol. 357] (d) Walsh's "Maxwell B" Lease, covering the SE/2 of the N/4 of Sec. 30, Bloack B-29, Public School Land, containing 53 acres, more or less, described in assign-

ment from F. H. E. Oil Company to F. Howard Walsh, dated October 4, 1940, and recorded in Vol. 89, Page 438, Assignment Records of Ward County;

(e) Walsh's "Maxwell A" Lease, covering 10 acres of land in the form of a square, located in the North corner of the SW 2 of the W 4 of Sec. 30, Block B-29, Public School Land, being the tract described in the assignment from F. H. E. Oil Company to F. Howard Walsh, dated October 4, 1940, and recorded in Vol. 89, Page 437, Assignment Records of Ward County.

(f) Walsh's "Wallis" Lease, covering the Southwesterly 175 acres of Sec. 19, Block 34, H. & T. C. Ry. Co. Survey, Ward County, except 40 acres out of the West corner of said Sec. 19, and being the tract described and conveyed in the assignment from F. H. E. Oil Company to F. Howard Walsh, dated October 4, 1940, and recorded in Vol. 89, Page 447, Assignment Records of Ward County,

reference being here made to each of said recorded instruments above referred to, for a more particular description of said oil and gas leases and the tracts covered thereby; and

Whereas, in trade and exchange for the interests herein conveyed, C. C. Cross has this day conveyed to said Walsh certain real property located in Tarrant County, Texas;

Now, Therefore, in consideration of the premises, the undersigned grantor, F. Howard Walsh, does hereby, sub- [fol. 358] ject to the conditions and limitations hereinafter set out, bargain, sell, assign and convey unto C. C. Cross, of Tarrant County, Texas, his heirs and assigns, the following described overriding royalty and mineral interests carved out of the interests owned by the undersigned grantor in and to the oil and gas leases and leasehold estates, insofar as they cover the tracts of land and leases described above, such interests herein conveyed being the following fractional parts of the oil in, under, or upon, or that may be produced from such tracts of land under the terms of said leases, to-wit:

(a) 1/4 of 7/8 of such oil, insofar as all of the tracts and leases in Ward County above described are concerned, save and except Walsh's "Killough" Lease; and

(b) 1/4 of 7/16 of such oil, insofar as such Killough Lease is concerned.

This grant is made subject to the following conditions and limitations, to wit:

(a) No interest in gas, casinghead gas or any other mineral except liquid petroleum shall be conveyed and assigned.

(b) All of the development and operating costs and expenses incurred in developing and operating said properties shall be borne exclusively by Walsh, insofar as the parties hereto are concerned.

(c) When and if Cross, or his heirs and assigns, shall have received, under the terms of said conveyance and assignment, oil of the net value of Sixty Five Thousand [fol. 359] and No 100 Dollars ($65,000.00), plus interest at the rate of seven (7) per cent per annum on the balances unpaid from time to time (exclusive of gross production taxes, which may be deducted from Cross's part of the oil), —then Cross shall have no further interest in said oil and gas leases or leasehold estate, and the oil then remaining in, under or upon said tracts of land, or thereafter produced therefrom; and the interests hereby conveyed shall automatically revert to Walsh, his heirs and assigns.

(d) Walsh shall pay all ad valorem taxes hereafter to be imposed upon the interests herein conveyed to Cross.

(e) This conveyance shall be effective as of seven o'clock, A. M., on October 1, 1949, and covers and includes the above described fractional parts of the oil produced, saved and sold from and after that date and hour.

Executed this 5th day of October, A. D., 1949.

F. Howard Walsh.

[fol. 360] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 361] Minute Entry of Argument and Submission—December 3, 1956.

(omitted in printing)

[fol. 362] IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 15981

WM. FLEMING AND BESSIE M. FLEMING, (Husband and Wife), F. Howard Walsh and Mary D. Walsh, (Husband and Wife) and Mary D. Fleming Walsh, Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

versus

WM. FLEMING AND BESSIE M. FLEMING, (Husband and Wife), F. Howard Walsh and Mary D. Walsh, (Husband and Wife) and Mary D. Fleming Walsh, Respondents.

Petitions for Review of Decisions of The Tax Court of the United States (District of Texas).

OPINION—February 1, 1957

Before: HUTCHESON, Chief Judge, and HOLMES and BORAH, Circuit Judges.

[fol. 363] HUTCHESON, *Chief Judge:* These consolidated appeals, brought by the taxpayers and commissioner, respectively, from decisions of the Tax Court,[1] involve income taxes for 1948 and 1949.

Three issues,[2] corresponding to the issues decided below,

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[1] 24 T.C. 818.

[2] These are: (1) The taxpayers exchange limited overriding royalty or oil payment interests (carved by them out of larger oil and gas interests) for, in one case, a ranch; and, in the other, urban business property.

The question is whether the exchanged properties were of "like kind" within the purview of Sec. 112(b)(1) Internal Revenue Code of 1939, so that, all other requirements

are presented for review, Issues Nos. 1 and 2 on the taxpayers', and Issue No. 3 on the commissioner's petition.

Submitted on stipulated facts,[3] there were findings in accordance therewith, and a decision against taxpayers [fol. 364] on the two issues appealed by them, and in their favor on the issue appealed by the commissioner.

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of said section being met, no taxable gain from the exchanges is to be recognized.

(2) Taxpayer, Mrs. Walsh, in 1943, agreed with a life insurance company that the proceeds of a 10 year endowment life insurance policy on her life—maturing in 1945—should, after such maturity, be held by the insurance company for an indefinite period of time, not within her control, and, during the first ten years of this extended period, improved with interest, after which interest on the total amount was to be paid to her periodically for the remainder of her life and thereafter as she directed in the agreement.

The question is whether the amounts of the interest improvements in 1948 and 1949, not paid or subject to withdrawal in those years, were nevertheless constructively received during said years by Mr. and Mrs. Walsh—"cash basis" taxpayers.

(3) If the first question presented by the taxpayers is decided adversely to them, then should the Tax Court's holding that said exchanges produced long-term capital gain be affirmed, or should the Commissioner be sustained in his contention that the taxpayers merely assigned future income and thereby received ordinary depletable income.

[3] Those pertinent to the first and third issues may be thus summarized:

All of the tax returns involved were filed upon the cash receipt and disbursement basis. Wm. Fleming, the partnership, Fleming Oil Co., Wm. Fleming, Trustee, and F. Howard Walsh, and each of them, were, among other activities, engaged in the business of producing oil and gas. All of the oil and gas properties held by any of those just named and involved in this proceeding had been held by them for several years for productive use in their said trade or business and not for sale.

On May 19, 1948, the Flemings acquired from Mrs. Cline—in the proportions of 50%, 25% and 25%—the fee simple title to some 2994.5 acres of ranching land situated in

[fol. 365] On their first question, taxpayers plant themselves firmly on two decisions of this court, *Commissioner* v. [fol. 366] *Chrichton*, 122 F(2) 181, holding that a city lot and mineral interests, and *Fleming v. Campbell*, 205 F(2)

Parker and Tarrant Counties, Texas, and thereafter held said lands for investment and not for sale.

The sole consideration given Mrs. Cline for this ranch was the assignment to her by the Flemings of limited overriding royalty or oil payment interests in various producing oil and gas properties then owned by the respective transferrors, and by the terms of the transfer Mrs. Cline became entitled to various fractions of the oil thereafter to be produced from the properties until she had received: from the Fleming Oil Company assignment—oil of the value of $147,000; from the Wm. Fleming assignment—oil of the value of $73,500; from the two Wm. Fleming Trustee assignments—oil of the value of $49,000 and $24,500, respectively, plus the same interest-factor in all. One of the Trustees' oil *payment assignments was out of leasehold interests, the other out of a royalty interest.*

The assignment from Fleming Oil Co. is typical and only its pertinent terms will be set out. It involved four ordinary commercial oil and gas leaseholds in which Fleming Oil Company was then the owner of an undivided one-half interest; and recited that for a valuable consideration Fleming Oil Company conveyed to Mrs. Cline:

> "The following described real property, to-wit, An overriding royalty or mineral interest carved out of the interest owned by Fleming Oil Company in each and all of the oil and gas leases above described, amounting to an undivided 48/128 interest in and to all of the oil in, under and that may be produced, saved and marketed from the above described tracts of land under the terms of the oil and gas leases covering the same, until the grantee above named shall have received therefrom oil of the net value of $147,000, plus an amount equal to 5% interest per annum from May 19, 1948, on the portions of the said $147,000 which may be unsatisfied from time to time."

The instrument further provided that no interest in gas, casinghead gas or in the personal property then on or there-

[fol. 367] 548, holding that oil payments and perpetual mineral or royalty interests, were properties of like kind. Insisting that these cases, holding in accordance with long standing regulations that the statutory phrase "like kind"

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after placed upon the property was conveyed; that grantee was to be entitled to receive the amount specified from the fractional part of the oil conveyed in addition to such gross production or severance taxes as might be imposed thereupon; that the conveyance was effective June 1, 1948; that all development and operating costs and expenses were to be borne by Fleming Oil Company; and that, when the grantee had received oil of the net value specified, her interest was to terminate. The instrument also provided:

> "The execution of this conveyance shall not impose upon grantor any obligation with respect to developing or operating the property covered hereby, nor shall it be implied herefrom the grantor is in anywise obligated to see that grantee receives oil aggregating the net value of $147,000, plus an amount equal to 5% as above provided, or any lesser sum; but grantor does covenant and agree that grantee shall have the same but no greater right to require the grantor to develop and operate said property, in accordance with the terms of the original lease upon said property, as the original lessors therein, their heirs or assigns, might have or exercise."

On Oct. 5, 1949, taxpayer F. Howard Walsh, in accordance with an existing agreement so to do, acquired from one C. C. Cross the fee simple title to revenue producing business real estate located in Fort Worth, Texas, and as the sole consideration for this conveyance, conveyed to Cross a limited overriding royalty or oil payment interest out of some six producing oil and gas leases in which Walsh then owned interests. The conveyance was in terms substantially similar to the terms of the Fleming Oil Company conveyance just summarized and entitled Cross to the specified fractions of oil, when, as and if produced, until he had received, free and clear of all costs and expenses, oil of the value of $65,000, plus an amount equal to interest on monthly declining balances at the rate of 7% per annum. Walsh acquired and has held the aforesaid business prop-

refers to the nature or character of the property interest and not to its grade or quality, they urge upon us that the exchanged properties, mineral interests for ranch lands in

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erty for investment and not for sale. All of the oil and gas leases involved were ordinary commercial oil and gas leases.

The properties acquired by the respective taxpayers in these exchanges had a fair market value equal to the face amount of the respective oil payments conveyed therefor.

It could be estimated at the time the case was submitted to the Tax Court that the oil payment assigned by Fleming Oil Co. would pay out in approximately 5 years and 8 months from its effective date; that from Wm. Fleming, in from 10 to 12 years from its effective date; and each of the oil payments assigned by Wm. Fleming, Trustee, in from 7 to 8 years from their respective dates. Likewise, it could have been estimated that the F. Howard Walsh oil payment would pay out in approximately 3½ years from its effective date.

Those pertinent to the second issue are:

The other issue presented involves Mr. and Mrs. Walsh only, and as to this issue the record discloses that on March 28, 1935 Mrs. Walsh (then Mary D. Fleming) acquired from Southwestern Life Ins. Co. a 10 year endowment policy in consideration of ten annual premiums of $2,245.75 each, which were duly paid. The policy provided that if the insured lived to the policy's maturity (March 28, 1945) the insured might within 31 days after such maturity select one of the following options of settlement:

1. $25,000 in cash;
2. $16,400 in cash and a paid up policy for $25,000; or
3. A paid up policy for $72,825.

On September 15, 1943—some year and a half before the policy matured—Mrs. Walsh entered into an agreement with the insurance company by which, at the maturity of the policy, the payment of the $25,000 proceeds was to be deferred—

> "* * * until paid as herein provided:
>
> "Interest on the unpaid portion of such sum at the guaranteed rate of three and one-half per cent per annum, and such additional interest, if any, as may be apportioned thereto by the Company from surplus in-

the Fleming transfers and mineral interests for urban real estate in the Walsh transfers, were of like kind.

The tax court judge, though agreeing that the oil payment assignments constituted mineral interests and, there-

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terest earnings, shall be added to the principal on March 28, each year, until March 28, 1955, and thereafter paid monthly as it accrues, subject to the limitation hereinafter specified, the first payment to be made April 28, 1955. Such interest shall be paid to me, if living, otherwise to the payee or payees as hereinafter designated."

There followed in the agreement provisions for payment after Mrs. Walsh's death to her children and grandchildren, and the instrument concluded:

> "It is understood and agreed that the Agreement to be issued and dated March 28, 1945, pursuant to this request, cannot be changed or amended, but the beneficiary may be changed with the consent of William Fleming, my father, upon written request and proper endorsement thereon. All payments provided herein shall be payable at the Home Office of the Company in the City of Dallas, Texas."

In accordance with this, on March 28, 1945, the Life Insurance Company issued an instrument acknowledging the maturity of the policy and that in satisfaction of the obligations of the policy it—

> "Promises to pay at its Home Office in the City of Dallas, Texas, the proceeds of said policy in accordance with the option method of settlement selected by Mary D. Fleming Walsh, the insured, in writing, a photostatic copy of such election being hereto attached and made a part hereof."

Nothing was paid to Mrs. Walsh, or anyone else, by the insurance company under said settlement agreement, during the years 1948 and 1949, and Mr. and Mrs. Walsh reported no income from that source in those years. But in determining the deficiencies due by Mr. and Mrs. Walsh for 1948 and 1949 the Commissioner treated as interest income constructively received by them $2,132.18 and $2,206.81, respectively; these amounts being the amounts added to the principal due under the interest provision above quoted from the settlement agreement.

fore, interests in land, was of the opinion that, because the duration of these mineral interests was measured by and limited to oil of the value named in the assignments, the properties exchanged were not of like kind. In short, holding that one was an unlimited, the other a limited, interest in lands, he thought that the sufficient distinction between this and the Chrichton case was that the mineral interest exchanged for urban lands there was an unlimited and not a limited, mineral interest. He thought that the Fleming case could be distinguished because, while it involved a limited mineral interest, a limited overriding royalty or oil payment, the exchange there was of that interest solely for undivided fractional oil, gas and other mineral interests. To which the taxpayers reply that if, as was held in the Chrichton case, the exchange of an unlimited mineral [fol. 368] interest for urban property was an exchange of like kind and in the Fleming case that an exchange of limited, for unlimited, mineral interests was also an exchange of like kind, it must follow, upon the principle that things equal to the same thing are equal to each other, that any of the properties involved in the two exchanges, if exchanged for any involved in the other, would result in exchanges of like kind.

On this issue, Judge Borah dissenting, we agree with taxpayers.

In *Commissioner v. Chrichton*, 122 F(2) 181, we pointed out that the invoked section, 112 (b)(1), is so general in its terms as to render an interpretative regulation appropriate and that the Treasury regulation invoked and sought to be applied was appropriate and valid.

In *Fleming v. Campbell*, 205 F(2) at p. 549, quoting in the margin from the Chrichton case,[4] we rejected the argu-

[4] "* * * the regulation and the interpretation under it, leave in no doubt that no gain or loss is realized by one, other than a dealer, from an exchange of real estate for other real estate, and that the distinction intended and made by the statute is the broad one between classes and characters of properties, for instance, between real and personal property. It was not intended to draw any distinction between parcels of real property however dissimiliar they may be in location, in attributes and in capacities for profitable use." Com. v. Crichton, 121 F.(2) at p. 182.

ment of the collector "that the mineral interest in the Ector County lands was an interest in fee and that in the Gregg County lands, for which it was exchanged, was a leasehold of a fee which does not have thirty or more years to run, and that, therefore, under the regulation the [fol. 369] interests exchanged were not of like kind", saying:

> "We cannot agree. In the first place, both interests exchanged were interests in land. (citing in note 5 many cases). In the second place, neither interest was a 'leasehold of a fee' in the sense in which that term is used in the regulation. Both were interests in minerals in place. Both were therefore interests in land, interests not in personal but in real property, in short, real rights."

We are, therefore of the opinion that, in those two cases, this court, in principle, decided the question presented here, and that, upon the authority of those decisions, the judgment of the tax court on the first issue must be reversed.

If we assume that we are in error in this view, and we, therefore, reach the third issue, note 2, *supra*, raised on the commissioner's appeal, that the tax court erred in holding that the transactions were exchanges of property giving rise to capital gains treatment and not anticipatory assignments of income, we find ourselves in agreement with the tax court, and, for the reasons set out in *Scofield v. O'Connor* and *Lake v. Commissioner*, this day decided, we affirm its judgment on this issue.

We come then to a consideration of the taxpayers' second issue, raised by the Walsh appeal, that the tax court erred in holding that the amounts added in 1948 and 1949 under the amended contract with the insurance company, though not paid to taxpayers in those years, were subject to tax [fol. 370] payers' withdrawal and, therefore, constructively received. The tax court, stating:

> "Petitioner [Mrs. Walsh] has deliberately turned her back on income, and has in effect selected the year in which she will report it. This she may not do. Further, the whole arrangement for the nonacceptance of income was voluntary on petitioner's part, she was

> in no way forced to surrender her right to the proceeds of the matured policy, and she could have had the interest paid to her currently as she did in the second agreement."

concluded:

> "Petitioner, a cash basis taxpayer, cannot escape income tax by directing that accrued interest be accumulated for her benefit in the future. See Theodore R. Bayard, 16 T.C. 1345." "

Here taxpayers insist that the commissioner and the tax court misunderstand the nature and effect of Mrs. Walsh's agreement and the law applicable thereto. Pointing out that under a valid and binding agreement made some eighteen months before the maturity of the policy and effecting a novation of the original agreement, the parties changed the terms of their contract, the taxpayers, citing *Commissioner v. Oates*, 207 F(2) 711 as precisely in point, insist that the commissioner and the court are undertaking to make for parties, who were competent to make and had made a valid agreement, an agreement that they did not make.

Pointing to the difference between the facts of this case and those dealt with in our case of *Williams v. United* [fol. 371] *States*, 219 F(2) 523; that there the taxpayer gained nothing by his agreement for the voluntary escrow of moneys admittedly due and payable to him, except, if the plan was successful, a reduction of his taxes and that this court correctly held that moneys so voluntarily escrowed by him were constructively received by him in the year of the escrow; whereas, in this case, there was a real contract in which both contracting parties obtained benefits; taxpayers insist that the Williams case is not against, but is in support of their contention.

We agree with taxpayers' contention. In the Williams case, the district judge and this court held that the transaction was not an installment sale but a completed one, the gain from which was immediately available and, therefore, taxable, to the seller in the year of its making, and the taxpayer could not, by voluntarily escrowing the pur-

chase price under an agreement that he should receive it in installments, defer payment of the taxes due on the sale.

There is nothing in this record indicating anything other than arms length business transactions between Mrs. Walsh and the company, a contract maturing in 1945, and an agreement entered into eighteen months before its maturity by which, instead of receiving the whole sum in 1945, she agreed with the company that it would hold the funds until 1955, another ten years, adding to the principal amount each year interest at an agreed figure plus such additional amounts as might be appropriated each year from the life insurance company's excess earnings. As a result of the [fol. 372] agreement, the amount of the interest added to the principal in 1948 and 1949 was greatly in excess of the guaranteed rate of $3\frac{1}{2}$ percent. In short, in 1943, when her new contract was made, Mrs. Walsh contracted for a greater rate than would have otherwise been available to her if she had continued to receive only current interest payments. In the years before this court, 1948 and 1949, Mrs. Walsh not only received nothing, she had no right to receive anything.

The judgment against taxpayers on this issue must be reversed.

The judgment of the tax court is Affirmed on the commissioner's appeal. On the taxpayers' appeal, it is Reversed and the cause is Remanded for tax redetermination in accordance herewith.

Judge Barah dissents from the decision on the first issue note 2 *supra*.

[fol. 373] In United States Court of Appeals for the Fifth Circuit

Wm. Fleming and Bessie M. Fleming (Husband and Wife), F. Howard Walsh and Mary D. Walsh (Husband and Wife), and Mary D. Fleming Walsh,

versus

Commissioner of Internal Revenue

No. 15981

Commissioner of Internal Revenue,

versus

Wm. Fleming and Bessie M. Fleming (Husband and Wife), F. Howard Walsh and Mary D. Walsh (Husband and Wife), and Mary D. Fleming Walsh.

Judgment—February 1, 1957

This cause came on to be heard on the petitions of Wm. Fleming and Bessie M. Fleming (Husband and Wife) and F. Howard Walsh and Mary D. Walsh (Husband and Wife), and Mary D. Fleming Walsh, and Commissioner of Internal Revenue for a review of decisions of The Tax Court of the United States, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court that the judgment of the said Tax Court on the Commissioner's appeal in this cause be, and the same is hereby, affirmed; and on the Taxpayers' appeal, that said judgment be, and it is hereby, reversed; and the cause is remanded to the said Tax Court for tax redetermination in accordance with the opinion of this Court.

"Borah, Circuit Judge, dissents from the decision on the first issue note 2 supra."

[fol. 374] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 375] [Caption omitted.]

[fol. 376] IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 16,055

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

versus

JOHN WEATHER AND NELL WEATHER, Respondents

Tax Court Docket No. 38,267

PETITIONER'S DESIGNATION AS TO PRINTING RECORD—Filed: April 26, 1956

The petitioner, the Commissioner of Internal Revenue, requests that only the following designated portions of the record be printed:

Docket entries; Amended petition; Answer to amended petition.

Report of proceedings dated June 14, 1954, only the following portions:

Beginning with the third line on page 32 and continuing through the first sentence, line 4, page 33;

Beginning with the ninth line on page 48 and continuing through line 21 on page 48;

[fol. 377] Stipulation of facts, from the beginning and continuing through paragraph 16, plus the signatures on last page;

Memorandum findings of fact, from the beginning and continuing through the fifth line on page 5 (down to "Issue II");

Decision; Petition for review and proofs of service; Court Order re transmission of original exhibits, original briefs and the official reports of proceedings.

Dated May 20, 1956.

(Signed) Charles K. Rice, Assistant Attorney General, Counsel for the Petitioner.

[fol. 378] IN THE TAX COURT OF THE UNITED STATES

Docket No. 38267

JOHN WEATHER AND NELL WEATHER, Husband and wife, Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent.

APPEARANCES:

For Petitioner: (Withdrawn), (Leslie E. Martlew, Esq.), (Withdrawn), (Robert Ash, Esq.), Allen E. Pye, Esq.

For Respondent: John P. Higgins, Esq., R. C. Whitley, Esq.

DOCKET ENTRIES

1952

Jan. 4—Petition received and filed. Taxpayer notified. Fee paid.

Jan. 5—Copy of petition served on General Counsel.

Feb. 15—Answer filed by General Counsel.

Feb. 15—Request for hearing in Dallas, Texas filed by General Counsel.

[fol. 379] Feb. 21—Notice issued placing proceeding on Dallas, Texas calendar. Service of answer and request made.

1953

Jan. 2—Hearing set February 24, 1953, Dallas, Texas.

Feb. 20—Entry of appearance of Robert Ash as counsel filed.

Feb. 20—Motion to continue to the next Dallas calendar filed by petitioner. Granted.

Jul. 29—Hearing set October 19, 1953, Dallas, Texas.

Oct. 14—Motion for continuance to the next Dallas calendar filed by taxpayer. Agreed to. 10 14 53 Granted.

1954

Mar. 8—Hearing set June 14, 1954, Dallas, Texas.

Apr. 13—Motion for withdrawal of E. E. Martlew as counsel filed. Granted.

1954

Apr. 13—Entry of appearance of Allen E. Pye as counsel filed.

Apr. 29—Motion to withdraw as counsel Robert Ash, filed. 4-30-54 Granted.

May 17—Notice changing Courtroom.

May 21—Motion for leave to amend petition, amended petition lodged, filed by taxpayer.

May 21—Motion for leave to amend petition granted, amended petition filed.

May 24—Copy of motion and amendment served on General Counsel.

June 14—Hearing had before Judge Johnson, on merits. Permission granted respondent to file answer to amended [fol. 380] petition, filed at hearing. Submitted. Stipulation of facts and exhibits A-1 to JJ-36 attached filed. Briefs due July 29, 1954. Replies due August 30, 1954.

Jul. 27—Transcript of hearing 6-14-54 filed.

Jul. 28—Motion for extension to August 12, 1954 to file brief filed by General Counsel. 7-29-54 Granted.

Aug. 9—Brief filed by taxpayer. 8-13-54 Copy served.

Aug. 12—Brief filed by General Counsel. 8-13-54 Copy served.

Sept. 13—Petitioner's reply brief filed. Copy served.

1955

Apr. 26—Memorandum findings of fact and opinion filed, Johnson, Judge. Decision will be entered under Rule 50. Copy served 4-26-55.

Jun. 21—Motion for additional findings of fact with attached memorandum in support thereof filed by petitioner.

Jul. 13—Order, denying petitioner's motion of June 21, 1955, entered.

Jul. 22—Petitioner's computation filed. Copy served.

Jul. 22—Hearing set August 17, 1955, Washington, D. C., (Rule 50). Copy served.

Aug. 2—Respondent's computation filed.

Aug. 8—Memorandum in support of respondent's objections and computation filed by General Counsel. Copy served 8-10-55.

Aug. 17—Hearing had before Judge Turner, on settlement. Referred to Judge Johnson.

Aug. 17—Hearing had before Judge Johnson, on settlement. C.A.V.

1955

Aug. 18—Decision entered, Judge Johnson, Div. 10.
[fol. 381] Nov. 10—Petition for review by United States Court of Appeals, Fifth Circuit, with assignments of error filed by respondent.

Nov. 25—Proof of service filed. Petitioner and attorney. (2).

Dec. 21—Motion for extension to March 9, 1956 for preparation of the evidence, transmission and delivery of the record filed by respondent.

Dec. 22—Order extending time to March 9, 1956 for preparation of the evidence, transmission and delivery of the record, entered.

1956

Feb. 14—Motion for extension of time to April 23, 1956 for preparation of the evidence, transmission and delivery of the record filed by respondent.

Feb. 15—Order, granting extension to April 23, 1956 to prepare, transmit and deliver the record, entered.

Mar. 5—Transcript of hearing 8-17-55 filed.

Mar. 29—Certified copy of order of Court of Appeals, Fifth Circuit, directing the Tax Court to: (1) transmit all original exhibits received in evidence, including joint exhibits A-1 thru JJ-36, attached to stipulation of facts and all original briefs to Appellate Court ten days before hearing; and (2) include as part of the transcript of record the original official report of this proceeding, including the oral testimony, in lieu of a narrative statement of evidence, and the original official report of the hearing under Rule 50, filed.

Apr. 5—Agreed praecipe for record filed by respondent.

[fol. 382] In The Tax Court of The United States.
Washington

[Title omitted]

Amended Petition—Filed and received May 21, 1954

The above-named petitioners hereby petition for a redetermination of the deficiency set forth by the Commis-

sioner of Internal Revenue in his notice of deficiency (Internal Revenue Agent in Charge, Dallas, Texas), dated October 9, 1951, and as a basis of this proceeding, allege as follows:

1

Petitioners, husband and wife, resided at 25 Covington Drive, Longview, Texas. The petitioners filed a joint income tax return for the taxable years ended December 31, 1948, and December 31, 1949, with the Collector of Internal Revenue for Second Texas District, in Dallas, Texas.

[fol. 383] 2

The notice of deficiency, a copy of which is attached hereto and made a part of this petition by reference, is dated October 9, 1951.

3

The taxes in controversy are income taxes for the taxable years ended December 31, 1948, and December 31, 1949, in the amounts of $112,715.34 and $72,404.66, respectively.

4

The determination of the taxes set forth in the notice of deficiency is based upon the following errors:

(a) The Commissioner erroneously increased petitioners' distributable share of the partnership income from the George & Wrather Drilling Company, Mt. Carmel, Illinois, by the amount of $104,218.75, as the result of treating the gain from the sale of oil payments as ordinary income rather than as gain from the sale of capital assets held for more than six months.

(b) The Commissioner erred in determining Bad Debts, as set forth in said notice of deficiency for the taxable years ended December 31, 1948 and 1949, constituted capital investment with a corresponding capital loss upon the sale or worthlessness of the investment.

[fol. 384] 5

The facts upon which the petitioners rely in this proceeding are as follows:

(a) By conveyance dated August 16, 1948, T. W. George, Edmee May George, Fred B. Wimberly, Virginia Wimberly,

and the petitioners, individually and doing business as "George & Wrather Drilling Company," sold and conveyed to the Indiana Farm Bureau Cooperative Association, Inc., an oil payment in the amount of $12,500.00, to be paid out of 9/10 of 5/16 of 7/8 of all the oil produced and saved from property known as the Kieffer "A" Lease, said lease having been acquired by the grantors in 1947.

(b) By conveyance dated August 16, 1948, T. W. George, Edmee May George, Fred B. Wimberly, Virginia Wimberly, and the petitioners, individually and doing business as "George & Wrather Drilling Company," sold and conveyed to the Indiana Farm Bureau Cooperative Association, Inc., an oil payment in the amount of $155,000.00, to be paid out of 9/10 of 5/16 of 7/8 of all the oil produced and saved from property known as the Kieffer "A" Lease, said lease having been acquired by the grantors in 1947.

(c) By conveyance dated August 16, 1947, T. W. George, Edmee May George, Fred B. Wimberly, Virginia Wimberly, and the petitioners, individually and doing business as "George and Wrather Drilling Company," sold and conveyed to the Indiana Farm Bureau Cooperative Association, Inc., an oil payment in the amount of $130,000.00 to be paid out of 9/10 of 7/24 of 7/8 of all the oil produced and [fol. 385] saved from the property known as the Brown Lease, said lease having been acquired by the grantors in 1946.

(d) The aforementioned sales of property resulted in long term capital gain of $287,500.00 to the partnership of George & Wrather Drilling Company, and petitioners' distributable share of such capital gain is $145,179.29.

[fol. 386] Wherefore, the petitioners pray that the Court may hear the proceeding and:

1. Determine that the Commissioner erred in treating the gain from the sale of oil payments as ordinary income in the taxable year ended December 31, 1948, as set forth in the notice of deficiency, thereby increasing petitioners' share of the ordinary income of the partnership and decreasing their share of long term capital gain;

[fol. 387] 3. Grant such other and further relief as the Court may deem proper.

Allen E. Pye, Attorney for Petitioners, P. O. Box 629, Tyler, Texas.

ATTACHMENT TO AMENDED PETITION

U. S. Treasury Department

Office of Internal Revenue Agent in Charge, Mercantile Commerce Building, Dallas 1, Texas

October 9, 1951.

DALLAS
IRA: 90D:D

Mr. John Wrather and
Mrs. Nell Wrather,
Husband and Wife
512 Southwest Reserve Life Building
Longview, Texas

DEAR MR. and MRS. WRATHER:

You are advised that the determination of your income tax liability for the taxable years ended December 31, 1948 and 1949, discloses deficiencies of $122,715.34 and $72,404.66, respectively, as shown in the statement attached. [fol. 388] In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency or deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, 2nd Floor, Mercantile Commerce Building, Dallas 1, Texas, for the attention of C:RLP. The signing and filing of this form will expedite the closing of your returns by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days

after the filing of the form, or on the date assessment is made, whichever is earlier.

Very truly yours, John B. Dunlap, Commissioner, By /s/ E. A. Peavy, Internal Revenue Agent in Charge.

Enclosures: Statement, Form of Waiver.

[fol. 389] DALLAS
IRA 90:90D:D

Statement

Mr. John Wrather, and Mrs. Nell Wrather, Husband and Wife, 512 Southwest Reserve Life Bldg., Longview, Texas

Income Tax Liability for the Taxable Years Ended December 31, 1948 and 1949

Year	Deficiency
1948	$112,715.84
1949	72,404.66
Total	$185,120.00

In making this determination of your income tax liability careful consideration has been given to the report of examination dated April 17, 1951.

[fol. 390] Taxable Year Ended December 31, 1948

Adjustments To Net Income

Net income as disclosed by joint return		$106,422.06
Unallowable deductions and additional income:		
(a) Excessive depletion	$2,565.23	
(b) Excessive depreciation	3,981.53	
(c) Bad debts	111,805.76	
(d) Loss on abandoned leases	3,875.27	
(e) Partnership income—George & Wrather Drilling Company, Mt. Carmel, Illinois	104,218.75	
Total	$226,446.54	
Nontaxable income and additional deductions:		
(f) Capital gains decreased	$70,736.03	
(g) Capital loss	1,000.00	
(h) Partnership income decreased—George & Wrather Drilling Company, Longview, Texas	1,754.00	
(i) O-80-Grape Bottling Company	7,302.67	
Total	$80,792.70	
[fol. 391]		
Net addition		145,653.84
Your net income adjusted		$252,075.90

Explanation of Changes

(a) Depletion is allowed in the amount of $129,952.33, instead of $132,517.56, and the difference, $2,565.23, is disallowed.

(b) Depreciation on well and lease equipment was found allowable in the amount of $11,426.78. Since $15,407.81 was claimed in the return, the excess, or $3,981.03, is disallowed.

(c) Advances to three O-SO-Grape Bottling Companies totalling $111,805.76 were deducted as bad debts by you, but are held to be additional cost of your investment and are to be so considered upon disposition of your interests in these companies. See Exhibits A and B.

The amounts to the three companies were as follows:

O-SO-Grape Bottling Company, Houston, Texas	$ 49,267.86
O-SO-Grape Bottling Company, San Antonio, Texas	45,782.47
O-SO-Grape Bottling Company, Longview, Texas	16,755.43
Total	111,805.76

[fol. 392] (d) The cost of the Wilson lease, $3,875.27, is disallowed as a loss in 1948. The leasehold cost should have been recovered through depletion during the production period.

(e) and (f) Partnership income from George and Wrather Drilling Company, Mount Carmel, Illinois has been adjusted to include your share of proceeds from sale of oil payments as ordinary income, (e), $104,218.75 and since you reported capital gain, and Exhibit A shows a net loss, the whole amount of capital gain reported is eliminated in (f), $79,736.03 per return. See item (g) below for allowance of loss.

(g) See Exhibit A for computation of the loss, and the carry-over to 1949. Amount allowed for 1948, $1,000.00.

(h) This adjustment is to eliminate the short-term capital gain from George & Wrather Drilling Company, Longview, Texas, which is used in Exhibit A to compute the net loss carry-over, amount $1,754.00.

(i) Your share of the operating loss of O-SO-Grape

Bottling Company, Longview, Texas, was not claimed in the return and is allowed here in the amount of $7,302.67.

[fol. 393] Taxable Year Ended December 31, 1948

Computation of Income Tax

Net income as corrected	$252,075 90
Less: Exemption (2 x $600.00)	1,200 00
Income subject to tentative tax	$250,875 90
One-half of such income for joint return	$125,437 95
Tentative tax	$89,959 78 (1)
Tax Reduction: $68 00 plus 12% of $89,559.78	$10,815 17 (2)
Normal tax and surtax (1) minus (2)	$79,144 61
Multiply amount of combined tax by 2 for joint return—Income tax liability	$158,289 22
Income tax liability disclosed by return, Account No. 3196319	45,573 88
Deficiency in income tax	$112,715 34

[fol. 394] Taxable Year Ended December 31, 1949

Adjustments To Net Income

Net income as disclosed by joint return		$100,917 16
Unallowable deductions and additional income:		
(a) Excessive depletion	$957 33	
(b) Excessive depreciation	2,443 48	
(c) Other losses claimed	109,230 67	
Total	$112,631 48	
Additional deductions:		
(d) Dependents' earnings	$738 25	
(e) Contributions	7,811 89	
(f) Income from sale of assets	1,362 13	
(g) Capital loss	1,000 00	
Total	$10,912 27	
Net addition		$101,719 21
Net income adjusted		$202,636 37

Explanation of Adjustments

(a) Depletion is allowed in the amount of $117,013.70, instead of $117,971.08, as claimed and the difference of $957.33 disallowed.

[fol. 395] (b) Depreciation on well and lease equipment is allowed in the amount of $13,415.16, instead of $15,858.64, as claimed and the excessive amount, $2,443.48, disallowed.

(c) Advances and expenditures totalling $109,230.67 for the O-SO-Grape Company of San Antonio, Texas, claimed

as an ordinary loss is held to be a long-term capital loss. See Exhibit B for inclusion in cost of this amount and the bad debt disallowed in 1948 ($45,782.47) for advances to this company.

(d) Your dependents' earnings are not taxable to you and are, therefore, eliminated here.

(e) Income adjustments above have increased your adjusted gross income so that 15% thereof exceeds the total contributions and the full amount is deductible.

Contributions allowed	$25,620.80
Amount deducted	17,808.91
Additional amount allowed	7,811.89

(f) Income from the sale of bottling equipment and other assets, $1,362.13, is eliminated here since it is shown in Exhibit B, capital gains.

(g) The amount of the net capital loss allowable in this year is deducted here, $1,000.00. See Exhibit B.

[fol. 396] Taxable Year Ended December 31, 1949

Computation of Income Tax

Net income as corrected		$202,636 37
Less: Exemption (4 x $600.00)		2,400 00
Income subject to tentative tax		$200,236 37
One-half of such income for joint return		$100,118 19
Tentative tax		$67,425 19 (1)
Tax Reduction: $68 00 plus 12% of $67,025.19		$8,111 02 (2)
Normal tax and surtax (1) minus (2)		$59,314 17
Multiply amount of combined tax by 2 for joint return—Income tax liability		$118,628 34
Income tax liability disclosed by return, Account No. BB/C 209		46,223 68
Deficiency in income tax		$72,404 66

[fol. 397]

EXHIBIT A

Sale of Assets—1948

Asset	Unrecovered Cost	Sales Price	Gain (Loss)	Taken Into Account
Morris Lease Equipment	$1,603.60	$7,362.31	$5,758.71	$2,879.36
Alexander Lease Equipment	1,033.37	930.00	(103.37)	(51.69)
Miscellaneous Equipment	195.66	227.50	31.84	15.92
1947 Dodge Auto	1,500.54	1,225.00	(275.54)	(137.77)
1941 Chrysler Auto	—0—	500.00	500.00	250.00
Navion Plan-	6,802.50	6,550.00	(252.50)	(126.25)
Beechcraft Plane	9,445.00	9,145.00	(300.00)	(150.00)
Wheeler Boat	14,488.00	13,500.00	(988.00)	(494.00)
McLin Lease	1,432.06	1,500.00	67.94	33.97
Partnership Interest— 2/3 O-SO-Grape Bottling Co., Longview, Texas (1)	36,417.08	20,000.00	(16,417.08)	(8,208.54)
Individual Totals	$72,917.81	$60,939.81	($11,978.00)	($5,989.00)

[fol. 398]

Less: Short-term capital gain, George & Wrather Drilling Co., Longview, Texas	1,754.00	
Basis in plane and boat considered to be personal:		
Navion Plane, 10% of $126.25	12.63	
Wheeler Boat, 50% of $494.00	247.00	
Long-term gain, George & Wrather Drilling Co., Mt. Carmel, Ill.	1,429.29	3,442.92
Capital Loss for 1948		$2,546.08
Amount deductible 1948		1,000.00
Capital loss carry-over to 1949		$1,546.08

[fol. 399]

(1) Basis of Partnership Interest:		
Purchase of 2/3 interest at 11-25-47 (note given)		$19,000.00
Cash advances from 11-25-47 to 9-24-48		16,839.43
Assumption of liability O-SO-Grape Co., Houston, Texas		3,587.17
Assumption of liability O-SO-Grape Co., San Antonio, Texas		2,532.65
Payment of Lon Miller note 11-25-47		2,038.50
Total credits to capital		$43,988.75
Cash received in payment of accounts receivable due from O-SO-Grape Co., San Antonio, Texas	$269.00	
Operating loss from 11-25-47 to 9-24-48	7,302.67	
Total debits		7,571.67
Capital balance at date of sale		$36,417.08

[fol. 400]

Exhibit B

Capital Gains and Losses

Year Ended December 31, 1949

	Cost	Value or Sales Price	Gain (Loss)
Loss on liquidating dividend from O-SO-Grape Co., San Antonio, Texas	$195,013.14	$ 0,000.00	($155,013.14)
Sale of miscellaneous assets (long-term)			657.06
Long-term loss			$154,356.08
Amount taken into account			($77,178.04) x 2
Net capital loss carry-over from 1948 (Exhibit A)			($1,546.08)
Sale of bottling equipment (short-term)	20,000.00	20,705.07	705.07
Net capital loss for year 1949			($78,019.05)
Amount deductible for 1949			1,000.00
Net capital loss carry-over to 1950			($77,019.05)

[fol. 401]

Note:

Cost of stock of O-SO-Grape Company, San Antonio, Texas, is computed as follows:

Total capital paid in at date of incorporation, August, 1947	$1,000.00
Cash spent on behalf of the corporation from period January 27, 1947, to December 31, 1947	$126,260.25
Cash spent on behalf of the corporation for period January 1, 1948, to December 31, 1948	27,852.67
Advances from January 1, 1949, to September 22, 1949	40,900.22
Total	$196,013.14
Less: Refund to John Wrather in 1949, representing original cost of capital stock	1,000.00
Cost of stock at liquidation date	$195,013.14

The value placed on the assets is the same amount bid by Wrather in the foreclosure sale as follows:

Equipment	$20,000.00
Real estate and building	$20,000.00
Value in liquidation	$40,000.00

[fol. 402] IN THE TAX COURT OF THE UNITED STATES

[Title omitted]

ANSWER TO AMENDED PETITION - Filed June 14, 1954

Comes now the Commissioner of Internal Revenue, by his attorney, Daniel A. Taylor, Chief Counsel, Internal Revenue Service, and for answer to the amended petition filed in this proceeding, admits and denies as follows:

1

Admits the allegations contained in paragraph 1 of the amended petition.

2

Admits the allegations contained in paragraph 2 of the amended petition.

3

Admits the allegations contained in paragraph 3 of the amended petition.

[fol. 403]

4

(a) and (b) Denies that the Commissioner erred as alleged in subparagraphs (a) and (b) of paragraph 4 of the amended petition.

5

(a) to (c) Admits the allegations contained in subparagraphs (a) to (c), inclusive, of paragraph 5 of the amended petition.

(d) Denies the allegations contained in subparagraph (d) of paragraph 5 of the amended petition.

6

(a) and (b) Admits the allegations contained in subparagraphs (a) and (b) of paragraph 6 of the amended petition.

(c) Admits in June 1947 corporate books and records were opened for the O-So-Grape Bottling Company of Houston, Texas; and denies the remainder of the allegations contained in subparagraph (c) of paragraph 6 of the amended petition.

(d) to (f) Denies the allegations contained in subparagraphs (d) to (f), inclusive, of paragraph 6 of the amended petition.

(g) Admits the allegations contained in subparagraph [fol. 404] (g) of paragraph 6 of the amended petition.

(h) Denies the allegations contained in subparagraph (h) of paragraph 6 of the amended petition.

7

(a) and (b) Admits the allegations contained in subparagraphs (a) and (b) of paragraph 7 of the amended petition.

(c) Admits in June 1947 corporate books and records were opened for the O-So Grape Bottling Company of San Antonio, Texas; and denies the remainder of the allegations contained in subparagraph (c) of paragraph 7 of the amended petition.

(d) to (f) Denies the allegations contained in subparagraphs (d) to (f), inclusive, of paragraph 7 of the amended petition.

(g) Admits the allegations contained in subparagraph (g) of paragraph 7 of the amended petition.

(h) and (i) Denies the allegations contained in subparagraphs (h) and (i) of paragraph 7 of the amended petition.

Denies generally and specifically each and every allegation contained in the amended petition not hereinabove expressly admitted, qualified or denied.

[fol. 405] Wherefore, it is prayed that the determination of the Commissioner of Internal Revenue be approved.

(Signed) Daniel A. Taylor, JMK; Daniel A. Taylor, Chief Counsel, Internal Revenue Service.

Of Counsel: James L. Backstrom, Regional Counsel, John P. Higgins, Special Attorney, Internal Revenue Service.

JHP cjp 6 8 54

[fol. 406] In The Tax Court of The United States

[Title omitted]

Official Report of Proceedings Dated June 14, 1954
Filed July 27, 1954

* * * * * * *

Q. Now, do you recall how long you remained a member of that partnership, Mr. Wrather?

A. I don't recall the exact date we dissolved that, but they then entered into another partnership, and if I may explain, it happened this way: This George & Wrather Drilling Company, production company that I have told you about, was operating in Illinois, Indiana and Kentucky, and at the same time I was operating personally in East Texas, and everywhere else in Texas. I was also operating personally with Mr. Walters and Mr. Penn in what I have just told you, Wrather, Penn & Walters. It so happened that the war was over, the pipe loosened up—what I mean, you could get materials and also you could drill on smaller pieces of acreage. Now, during the time that the right to drill on small acreage was, I'd say stopped, on account of Federal regulations, I had acquired quite a few [fol. 407] leases in the East Texas Field. Some of those I acquired in my name, and some in the name of George & Wrather Production Company, with a view to drill them if, as, and when the regulations were lifted where we could drill them. Now, what happened, just as I had anticipated—we had quite a few wells to drill. We had drilling rigs in Illinois, so we sent two of those drilling rigs down to East Texas and drilled our own wells and several other wells we had found under certain contracts, and we brought Mr. Wimberly down at that time to look after them.

Q. George & Wrather?

A. George & Wrather Drilling Company.

* * * * * * *

Q. There was some talk about this partnership, George & Wrather and you and Mr. George and Mr. Wimberly were operating primarily up in the Illinois and Indiana fields?

A. It started primarily up there, but then later on we did operate in Texas, and as far as that goes, we operated in Wyoming and Oklahoma.

Q. What kind of work did George & Wrather do, primarily, drilling or producing?

A. Both drilling and producing. Most of the time they would sell interests in the leases and probably retain an eighth in it, or a quarter, and in some cases a half, and drill the wells, and then, of course, if we got oil, well, why then, we developed it.

* * * * * * *

[fol. 408] IN THE TAX COURT OF THE UNITED STATES

[Title omitted]

STIPULATION OF FACTS—Filed June 14, 1954

It is hereby stipulated and agreed between the Commissioner of Internal Revenue and the above entitled taxpayers, by their respective undersigned attorneys, that the following facts shall be taken as true, provided, however, that this stipulation does not waive the right of either party to introduce other evidence not at variance with the facts herein stipulated, or to object to the introduction in evidence of any such facts on the grounds of immateriality or irrelevancy.

1

At all times pertinent to this proceeding, the Petitioners, John and Nell Wrather, were husband and wife, and resided in Longview, Texas.

[fol. 409] 2

On or about March 15, 1949, the Petitioners, John Wrather and wife, Nell Wrather, filed a joint income tax return for the calendar year 1948. The said return is attached hereto and marked Exhibit A-1.

3

On or about March 15, 1950, the Petitioners, John Wrather and his wife, Nell Wrather, filed a joint income tax return

for the calendar year 1949. The said return is attached hereto and marked Exhibit B 2.

4

At all times pertinent to this proceeding, the Petitioner, John Wrather, was a partner with T. W. George and F. B. Wimberly in a partnership doing business as George & Wrather Drilling Company, with its principal place of business located at Mt. Carmel, Illinois. The partnership return of George & Wrather Drilling Company is attached hereto and marked Exhibit C 3.

5

By conveyances dated July 29, 1946, December 23, 1946, and July 1, 1947, T. W. George, John Wrather, and F. B. Wimberly, as co-partners doing business as George & Wrather Drilling Company, received from T. W. George and wife, Edmee May George, an assignment of oil and gas leases on a tract of land known as the Brown Lease. Copies of said assignments are attached hereto and marked Ex- [fol. 410] hibits D 4, E 5, and F 6. Proceeds of the sale of production from the Brown Lease were first received by George & Wrather Drilling Company in June, 1947.

6

By conveyance dated June 19, 1948, T. W. George, Edmee May George, F. B. Wimberly, Virginia Wimberly, John Wrather, and Nell Wrather, individually, and doing business as George & Wrather Drilling Company, sold and conveyed to the Indiana Farm Bureau Cooperative Association, Inc., an oil payment in the amount of $130,000.00, to be paid out of 9/10 of 7/24 of 7/8 of all the oil produced and saved from the Brown Lease. A copy of said oil payment assignment is attached hereto and marked Exhibit G 7.

7

In consideration of the assignment of the oil payment interest in the Brown Lease, the Indiana Farm Bureau Cooperative Association, Inc., paid to the George & Wrather Drilling Company the sum of $125,000.00 cash, on or about the date of the assignment.

8

By conveyance dated November 24, 1947, T. W. George, John Wrather, and F. B. Wimberly, as co-partners doing business as George & Wrather Drilling Company, received an assignment of oil and gas leases known as the Kieffer "A" Lease. A copy of said assignment is attached hereto and marked Exhibit H-8. Proceeds of the sale of produc-
[fol. 411] tion from the Kieffer "A" Lease were first received by the George & Wrather Drilling Company in November, 1947.

9

By conveyance dated June 19, 1948, T. W. George, Edmee May George, John Wrather, Nell Wrather, F. B. Wimberly and Virginia Wimberly, individually, and doing business as George & Wrather Drilling Company, sold and conveyed to the Indiana Farm Bureau Cooperative Association, Inc., an oil payment in the amount of $155,000.00, to be paid out of 9/10 of 5/16 of 7/8 of all the oil produced and saved from the Kieffer "A" Lease. A copy of said oil payment assignment is attached hereto and marked Exhibit I-9.

10

By conveyance dated August 16, 1948, T. W. George, Edmee May George, John Wrather, Nell Wrather, F. B. Wimberly, and Virginia Wimberly, individually, and doing business as George & Wrather Drilling Company, sold and conveyed to the Indiana Farm Bureau Cooperative Association, Inc., an oil payment of $12,500.00, to be paid out of 9/10 of 5/16 of 7/8 of all the oil produced and saved from the Kieffer "A" Lease. A copy of said oil payment assignment is attached hereto and marked Exhibit J-10.

11

In consideration of the assignments of the oil payment interest out of the Kieffer "A" Lease as set forth in Paragraphs 9 and 10 above, the Indiana Farm Bureau Cooperative Association, Inc., paid George & Wrather Drilling
[fol. 412] Company the sum of $162,500.00 cash, on or about the dates of the assignments.

12

In June, 1948, the Indiana Farm Bureau Cooperative Association, Inc., first received proceeds from the sales of production attributable to its oil payment interests in the Kieffer "A" and Brown Leases.

13

By June, 1952, the Indiana Farm Bureau Cooperative Association, Inc., had received $130,000.00 as proceeds attributable to its oil payment interest in the Brown Lease.

14

By November, 1953, the Indiana Farm Bureau Cooperative Association, Inc., had received $167,500.00 as proceeds attributable to its oil payment interest in the Kieffer "A" Lease.

15

At the time that the George & Wrather Drilling Company conveyed to Indiana Farm Bureau Cooperative Association, Inc., the oil payment interests out of the Kieffer "A" and Brown Leases, it could be reasonably calculated that said oil payments would pay out in approximately four to six years.

[fol. 413]

16

At all times pertinent hereto, the George & Wrather Drilling Company held the Kieffer "A" and Brown Leases for the development and production of oil, gas, and other minerals therefrom.

(Signed) Daniel A. Taylor, ATA; Daniel A. Taylor, Chief Counsel, Internal Revenue Service; Allen E. Pye, Attorney for Petitioners.

[fol. 414] IN THE TAX COURT OF THE UNITED STATES

Docket No. 38267

JOHN WRATHER and NELL WRATHER, Husband and Wife, Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent

T. C. Memo. 1955-104

Allen E. Pye, Esq., for the petitioners.
John P. Higgins, Esq., for the respondent.

Memorandum Findings of Fact and Opinion—Filed April 26, 1955

JOHNSON, *Judge:* Respondent determined deficiencies in petitioners' income tax for 1948 and 1949 in the amounts of $112,715.34 and $72,404.66, respectively. The following issues are presented in this proceeding:

(1) Was petitioners' gain from the sale of an oil payment in 1948 ordinary income or capital gain?

(2) Were petitioners entitled to certain claimed bad debt deductions for 1948 and 1949?

(Seal.)

[fol. 415] FINDINGS OF FACT

Some of the facts are stipulated and are incorporated herein by this reference.

John and Nell Wrather, husband and wife, were residents of Longview, Texas. They filed joint tax returns for 1948 and 1949 with the collector of internal revenue for the second district of Texas. John Wrather will hereinafter be referred to as the petitioner.

Issue I

Facts.—During 1948 and 1949 petitioner, T. W. George, and F. B. Wimberly were partners in a business known as George & Wrather Drilling Company, hereinafter referred to as the partnership.

In 1948, petitioner, George and Wimberly, as partners, held certain oil and gas lease assignments for tracts of land known as the Brown Lease and the Kieffer "A" Lease. Both leases were productive and had produced income for the partnership prior to 1948. By a conveyance dated June 19, 1948, the partners and their wives, as individuals and for the partnership, sold and conveyed to the Indiana Farm Bureau Cooperative Association, Inc., hereinafter referred to as the Cooperative, an oil payment in the amount of $130,000 to be paid out of 9/10ths of 7/24ths of 7/8ths of the oil produced and saved from the Brown Lease. In consideration for this oil payment assignment the Cooperative paid the partnership $125,000 in cash on or about the date of the assignment.

[fol. 416] By another conveyance dated June 19, 1948, the partners and their wives, as individuals and for the partnership, sold and conveyed to the Cooperative an oil payment in the amount of $155,000, to be paid out of 9/10ths of 5/16ths of 7/8ths of all the oil produced and saved from the Kieffer "A" Lease.

On August 16, 1948, the partners and their wives conveyed to the Cooperative another $12,500 oil payment out of the Kieffer "A" Lease. In consideration for these oil payments from the Kieffer "A" Lease, the Cooperative paid the partnership $162,500 cash on or about the date of the assignments.

In June 1948 the Cooperative received its first proceeds attributable to the oil payments from both leases. By January 1952, the Cooperative had received $130,000 from the Brown Lease and by June 1953, $167,500 from the Kieffer "A" Lease. The reasonable pay-out time on the three interests was calculated at the time of the assignments to be from four to six years.

Opinion.—In this first issue the questions of fact have been stipulated and the remaining question of law is whether petitioner's share of the gain from the sale of an oil payment is a capital gain or ordinary income. Petitioner reported the gain as capital gain but respondent determined it to be ordinary income.

The decision in this case is controlled by the decisions in prior cases involving the sale and exchange of oil payments. [fol. 417] In *Ortiz Oil Co.*, 37 B.T.A. 656, affd. 102 F. 2d

508, it was held that the grantor of an oil payment realized a taxable gain on the sale of an oil payment. The gain was based on the considerations received for the oil payment, but the court did not discuss the question of whether the gain was capital gain or ordinary income.

In a later case, *John David Hawn*, 23 T.C. 516, the Court was required to decide whether the consideration received by Hawn in exchange for an oil payment constituted capital gain or ordinary income. The Court, following *Lester et al. Nordan*, 22 T.C. 1132, held that Hawn's conveyance of an oil payment was a transfer of a capital asset, and the gain realized therefrom was taxable as capital gain.

Similarly, it was held by the Court of Appeals, Fifth Circuit, in *Caldwell* v. *Campbell*, 218 F. 2d 567, where a taxpayer transferred oil payments in exchange for cash and notes, that the oil payments were capital assets. The gain was then held to be taxable as capital gain.

Since the *Hawn*, *Nordan* and *Caldwell* cases have established that oil payments should be treated as capital assets, and since we are unable to distinguish the oil payments in the present case from those in the *Hawn*, *Nordan* and *Caldwell* cases, we must find that the oil payments conveyed by petitioner to the Cooperative were capital assets. Further, since there is no dispute that the properties were held for more than six months, petitioner's gain is taxable as capital gain under section 117 of the 1939 Code.

[fol. 418] In The Tax Court of The United States

[Title omitted]

Decision—Entered August 18, 1955

Pursuant to Memorandum Findings of Fact and Opinion of the Tax Court filed April 26, 1955, petitioners filed a computation on July 22, 1955, and on August 2, 1955, respondent filed a computation. On August 8, 1955, respondent filed an objection to petitioner's computation, and on August 17, 1955, a hearing was had thereon, at which both parties appeared. After due consideration of the computations of both parties and respondent's objection to petitioners' computation, it is

Ordered and Decided: That there are deficiencies in income tax for the calendar years 1948 and 1949 in the respective amounts of $37,962.81 and $72,404.66.

Luther A. Johnson, Judge.

Served August 19, 1955

[fol. 419] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 420] Exhibit D-4

Miscellaneous Gas and Oil Lease Record No. 28

Assignment of Oil and Gas Leases

Know All Men By These Presents: That the undersigned, T. W. George and Edmee May George, his wife, hereinafter called Assignors, for and in consideration of One Dollar ($1.00) to them in hand paid, the receipt and sufficiency whereof is hereby acknowledged, do hereby sell, assign, transfer and set over unto T. W. George, John Wrather and E. B. Wimberly, co-partners doing business as George Wrather Drilling Company, hereinafter called assignees, an undivided one twelfth (1/12) working interest in and to the following described oil and gas leases, to wit:

1. Oil and gas lease dated May 8, 1946, from Fred Horn and Garnett Horn, his wife, lessors, to Olen D. Sharp, lessee, recorded in Book 27, of Oil and Gas Leases at page 12 in the office of the Recorder of Wabash County, Illinois, which lease covers the following described real estate, to-wit:

All of the East Half ($E\frac{1}{2}$) of the Southeast Quarter ($SE\frac{1}{4}$) of Section 35, lying North of the Southern Railroad; and all of the West Half ($W\frac{1}{2}$) of the Southwest Quarter ($SW\frac{1}{4}$) of Section 36 lying North of the Southern Railroad; the tract in Section 35 containing 33 acres, and the tract in Section 36 containing 31 acres; situate in the County of Wabash in the State of Illinois, in Township 1 South, Range 14 West;

2. Oil and gas lease dated June 3, 1946, from Martha Brown, a widow, lessor, to Olen D. Sharp, lessee, recorded in Book 27 of Oil and Gas Leases at page 17 in the office of said Recorder, which lease covers the following described real estate, to wit:

> The North Half ($N\frac{1}{2}$) of the Southwest Quarter ($SW\frac{1}{4}$) and the South Half ($S\frac{1}{2}$) of the Northwest Quarter ($NW\frac{1}{4}$); all in Section 1, Township 2 South, Range 14 West, containing in all 160 acres, more or less, situate in the County of Wabash, in the State of Illinois;

3. Oil and gas lease dated May 8, 1946, from Charles Joachim and Maude Joachim, his wife, Lessors, to Olen D. Sharp, lessee, recorded in Book 27 of Oil and Gas Leases at page 18 in the office of said Recorder, which lease covers the following described real estate, to wit:

> The Northwest Quarter ($NW\frac{1}{4}$) of the Northeast Quarter ($NE\frac{1}{4}$) of Section Thirty-six (36); the Southeast Quarter ($SE\frac{1}{4}$) of the Northwest Quarter ($NW\frac{1}{4}$) of Section 36; and the East 18 acres of the Southwest quarter ($SW\frac{1}{4}$) of the Northwest Quarter ($NW\frac{1}{4}$) of Section 36; all in Township 1 South, Range 14 West, situate in the County of Wabash, in the State of Illinois;

4. Oil and gas lease dated May 10, 1946, from Harry Epler and Norma Epler, his wife, lessors, to Olen D. Sharp, lessee, recorded in Book 27, at page 15 in the office of said Recorder, which lease covers the following described real estate, to-wit:

> The Southeast Quarter ($SE\frac{1}{4}$) of the Northeast Quarter ($NE\frac{1}{4}$), excepting therefrom one (1) acre out of the Southeast corner, being Methodist Church property and Gilkison property, and excepting also filling station property described as follows: Commencing 434.5 feet North and 30 feet West of the Southeast Corner of the Northeast Quarter ($NE\frac{1}{4}$) of Section 36, Township 1 South, Range 14 West, for beginning; thence West 211 feet; thence North 43 degrees East along the Southerly right-of-way line of the State

Highway 340.5 feet; thence South along the West line of the right of way 223.5 feet to place of beginning, containing .54 of an acre, situate in the County of Wabash in the State of Illinois;

5. Oil and gas lease dated May 10, 1946, from Cyrus K. Gilkison and Garnett M. Gilkison his wife; Omar C. Gilkison and Ferrid D. Gilkison, his wife; Christina E. Wiseman and Bryan B. Wiseman, her husband; Violet McClain and Charles McClain, her husband; Maurice Yohe and Katherine Yohe, his wife; William C. Niblo and Teletha B. Niblo, his wife; Rudolph F. Niblo and Anna Niblo, his wife; and Thelma Niblo, a single person, lessors, to Olen D. Sharp, lessee, which lease is recorded in Book 27 at page 8 in the office of said Recorder and covers the following described real estate, to-wit:

The Northwest Quarter (NW^1_4) of the Southeast Quarter (SE^1_4) of Section 36, Township 1 South, Range 14 West, containing 40 acres, more or less.

The East Half (E^1_2) of the Southwest Quarter (SW^1_4) of the Northeast Quarter (NE^1_4) of Section 36, Township 1 South, Range 14 West, except a strip one-third ($^1_3$) of a rod wide off the East side of said tract, the tract containing 20.54 acres;

All that fraction of land lying South of the Southern Railway right of way in the Northwest Quarter (NW^1_4) of the Southwest Quarter (SW^1_4) of Section 36, Township 1 South, Range 14 West, containing 7 acres, more or less.

The Southeast quarter (SE^1_4) of the Southwest Quarter (SW^1_4) of Section 36, Township 1 South, Range 14 West, containing 40 acres, more or less;

The Northeast Quarter (NE^1_4) of the Southwest Quarter (SW^1_4) of Section 36, Township 1 South, Range 14 West, containing 40 acres, more or less;

The Southwest Quarter (SW^1_4) of the Southwest Quarter (SW^1_4) of Section 36, in Township 1 South, Range 14 West, containing 40 acres, more or less;

All that portion of land lying North of the Southern Railway right of way exclusive of Lots in the West Half (W^1_2) of the Northeast Quarter (NE^1_4) of the Southeast Quarter (SE^1_4) of Section 36, Township 1

South, Range 14 West, West of the Town of Bellmont, Illinois, containing 5 acres, more or less;

All situate in the County of Wabash in the State of Illinois.

[fol. 421] 6. Oil and gas lease dated May 8, 1946, from Thomas J. Brines and Hattie F. Brines, his wife, lessors, to Olen Sharp, lessee, recorded in Book 27, of Oil and Gas Leases, at page 11 in the office of said Recorder, which lease covers the following described real estate, to wit:

The West Thirteen (13) acres of the Southwest Quarter (SW^1_4) of the Northwest Quarter (NW^1_4) of Section 36; and the Southeast Quarter (SE^1_4) of the Northeast Quarter (NE^1_4) of Section 35; all in Township 1 South, Range 14 West, Wabash County, Illinois, and containing in all 53 acres, more or less.

7. Oil and gas lease dated April 26, 1945, from Blanche Ehrenberg and Theodore Ehrenberg, her husband, and Milton Taylor, her son, a single man, lessors, to Olen D. Sharp, lessee, recorded in Book 24 of Oil and Gas Leases at page 552 in the office of said Recorder, which lease covers the following described real estate, to wit:

The East ten (10) acres of the West half (W^1_2) of the Southwest Quarter (SW^1_4) of the Northeast Quarter (NE^1_4) of Section 36, Township 1 South, Range 14 West, situate in the County of Wabash, in the State of Illinois;

8. Oil and gas lease dated May 8, 1946, from Bryan Garrett and Viola Garrett, his wife; Mildred Garrett, a widow; H. Leo Garrett and Rachel Garrett, his wife; Irvin Garrett and Ruth Garrett, his wife; and Howard E. Garrett, a single man; lessors, to Olen D. Sharp, lessee, recorded in Book 27 at page 13 in the office of said Recorder, which lease covers the following described real estate, to wit:

The North half (N^1_2) of the Northwest Quarter (NW^1_4) of Section One (1), Township 2 South, Range 14 West, and the Northeast Quarter (NE^1_4) of the Northeast Quarter (NE^1_4) of Section 2, Township 2 South, Range 14 West, containing 120 acres, more or less; also all that part of the West Half, (W^1_2) of the

Southeast Quarter (SE^1_4) of Section 35, lying South of the Southern Railroad, in Township 1 South, Range 14 West, containing 38 acres, more or less; situate in the County of Wabash in the State of Illinois.

Together with all the rights incident thereto and the personal property thereon, appurtenant thereto, or used or obtained in connection therewith.

And for the same consideration the assignors covenant with the Assignees, their heirs, and assigns: That the assignors are the lawful owners of and have good title to the interest above assigned in and to said leases, estates, rights and property, free and clear from all liens, encumbrances or adverse claims; that said leases are valid and subsisting leases on the lands above described, and all rentals and royalties due thereunder have been paid and all conditions necessary to keep the same in force have been duly performed; and Assignors hereby surrender and release all rights of dower and homestead in the premises above described, insofar as same may in any way affect the purposes hereof.

Executed this 29th day of July, 1946.

T. W. George, (Seal). Edmee May George, (Seal).

STATE OF ILLINOIS,
County of Wabash, ss:

I, J. K. Cline, a Notary Public, in and for said County in the State aforesaid, do hereby certify that T. W. George and Edmee May George, his wife, personally known to me to be the same persons whose names are subscribed to the foregoing instrument, appeared before me this day in person and acknowledged that they signed, sealed and delivered the said instrument as their free and voluntary act, for the uses and purposes therein set forth, including the release and waiver of the right of homestead.

Given under my hand and Seal, this 29th day of July, A. D. 1946.

J. K. Cline, Notary Public. (Notarial Seal).

Filed for record this the 6th day of November, A. D. 1946, at 9:55 o'clock A. M.

R. E. Friend, Recorder.

[fol. 422] EXHIBIT E 5

Miscellaneous Gas and Oil Record No. 30

Assignment of Interest in Oil and Gas Leases

Know all men by these presents, That the undersigned, T. W. George and Edince May George, his wife, hereinafter called Assignors, for and in consideration of One Dollar ($1.00) to them in hand paid, the receipt and sufficiency whereof is hereby acknowledged, do hereby sell, assign, transfer and set over unto T. W. George, John Wrather, F. B. Wimberly, co-partners doing business as George & Wrather Drilling Company, hereinafter called assignee, an undivided Two twenty-fourths (2/24) working interest in and to the following described oil and gas leases, to-wit:

1. Oil and gas lease dated May 8, 1946, from Fred Horn and Garnett Horn, his wife, lessors, to Olen D. Sharp, lessee, recorded in Book 27, of Oil and Gas Leases at page 12, in the office of the Recorder of Wabash County, Illinois, which lease covers the following described real estate, to-wit:

> All of the East Half ($E\frac{1}{2}$) of the Southeast Quarter ($SE\frac{1}{4}$) of Section Thirty-five (35), lying North of the Southern Railroad; and all of the West Half ($W\frac{1}{2}$) of the Southwest quarter ($SW\frac{1}{4}$) of Section Thirty-six (36) lying North of the Southern Railroad; the tract in Section 35 containing 33 acres, and the tract in Section 36 containing 31 acres; situate in the County of Wabash in the State of Illinois, in Township 1 South, Range 14 West.

2. Oil and gas lease dated June 3, 1946, from Martha Brown, a widow, lessor, to Olen D. Sharp, lessee, recorded in Book 27, of Oil and Gas Leases at page 17 in the office of said Recorder, which lease covers the following described real estate, to-wit:

> The North half ($N\frac{1}{2}$) of the Southwest Quarter ($SW\frac{1}{4}$) and the South Half ($S\frac{1}{2}$) of the Northwest Quarter ($NW\frac{1}{4}$) all in Section One (1), Township Two (2) South, Range Fourteen (14) West, containing in all 160 acres, more or less, situate in the County of Wabash in the State of Illinois;

3. Oil and gas lease dated May 8, 1946, from Charles Joachim and Maude Joachim, his wife, lessors, to Olen D. Sharp, lessee, recorded in Book 27 of Oil and Gas Leases at page 18 in the office of said Recorder, which lease covers the following described real estate, to wit:

> The Northwest Quarter (NW^1_4) of the Northeast Quarter (NE^1_4) of Section Thirty-six (36); the South, east quarter (SE^1_4) of the Northwest quarter (NW^1_4) of Section Thirty-six (36); and the East Eighteen (18) acres of the Southwest quarter (SW^1_4) of the Northwest Quarter (NW^1_4) of Section Thirty-six (36); all in Township One (1) South, Range Fourteen (14) West, situate in the County of Wabash in the State of Illinois.

[fol. 423] 4. Oil and gas lease dated May 10, 1946, from Harry Epler and Norma Epler, his wife, lessors, to Olen D. Sharp, lessee; recorded in Book 27 at page 15 in the office of said Recorder, which lease covers the following described real estate, to wit:

> The Southeast Quarter (SE^1_4) of the Northeast quarter (NE^1_4), excepting therefrom one (1) acre out of the Southeast corner, being Methodist Church property and Gilkison property, and excepting also filling Station property described as follows: Commencing 434.5 feet North and 30 feet West of the Southeast corner of the Northeast quarter (NE^1_4) of Section 36, Township 1 South, Range 14 West, for beginning; thence West 211 feet; thence North 43 degrees East along the Southerly right-of-way line of the State highway 310.5 feet; thence South along the West line of the right-of-way 223.5 feet to place of beginning, containing .54 of an acre, situate in the County of Wabash in the State of Illinois.

5. Oil and gas lease dated May 8, 1946, from Thomas J. Brines and Hattie F. Brines, his wife, lessors, to Olen D. Sharp, lessee, recorded in Book 27, of Oil and Gas Leases at page 11 in the office of said Recorder, which lease covers the following described real estate, to wit:

> The West Thirteen (13) acres of the Southwest quarter (SW^1_4) of the Northwest Quarter (NW^1_4)

of Section 36; and the Southeast Quarter (SE^1_4) of the Northeast Quarter (NE^1_4) of Section 35, all in Township 1 South, Range 14 West, Wabash County, Illinois, and containing in all 53 acres, more or less.

6. Oil and gas lease dated April 26, 1945, from Blanche Ehrenberg and Theodore Ehrenberg, her husband; and Milton Taylor, her son, a single man, lessors, to Olen D. Sharp, lessee, recorded in Book 24 of Oil and Gas Leases at page 552, in the office of said Recorder, which lease covers the following described real estate, to wit:

The East Ten (10) acres of the West Half (W^1_2) of the Southwest quarter (SW^1_4) of the Northeast quarter (NE^1_4) of Section Thirty six (36), Township 1 South, Range 14 West, situate in the County of Wabash in the State of Illinois.

7. Oil and gas lease dated May 8, 1946, from Bryan Garrett, and Viola Garrett his wife; Mildred Garrett, a widow; H. Leo Garrett, and Rachel Garrett, his wife; Irvin Garrett, and Ruth Garrett, his wife, and Howard E. Garrett, a single man, lessors, to Olen D. Sharp, lessee, recorded in Book 27, at page 13, in the office of said Recorder, which lease covers the following described real estate, to-wit:

The West Half (W^1_2) of the Southwest Quarter (SW^1_4) of the Northeast quarted (NE^1_4) of Section Thirty six (36), Township One (1) South, Range Fourteen West, containing 20 acres, more or less, situate in the County of Wabash in the State of Illinois;

8. Oil and gas lease dated May 8, 1946, from C. F. Brian, a widower; Blanche T. Runcie, a widow; and Pearl T. Kirsch and E. C. Kirsch, her husband, lessors, to Olen D. Sharp, lessee, recorded in Book 27, at page 21, in the office of said Recorder, which lease covers the following described real estate, to-wit:

The North half (N^1_2) of the Northwest Quarter (NW^1_4) of Section One (1), and the Northeast Quarter (NE^1_4) of the Northeast Quarter (NE^1_4) of the Northeast Quarter (NE^1_4) of Section Two (2), in Township 2 South, Range 14 West, containing 129

acres, more or less; also all that part of the West half (W½) of the Southeast Quarter (SE¼) of Section 35 lying South of the Southern Railroad, in Township 1 South, Range 14 West, containing 38 acres, more or less, situate in the County of Wabash, in the State of Illinois;

Together with all the rights incident thereto, and the personal property thereon, appurtenant thereto, or used or obtained in connection therewith.

The interest hereby assigned is made subject to and burdened with a one-half part of overriding royalty interest heretofore assigned by the assignor aggregating the 1/64 part of the 7/8 part of all oil and gas or either to be produced, saved and marketed from said lands under the terms of said leases, free and clear of all cost to the holders of such aggregate interest. This assignment is not subject to such overriding royalty interest, and such overriding royalty interest shall be borne by and burdened upon the Working Interest remaining in the name of the Assignor.

And for the same consideration the assignors covenant with the assignee, his heirs and assigns; That the assignors are the lawful owners of and have good title to the interest above assigned in and to said leases, estates, rights and property, free and clear from all liens, encumbrances, or adverse claims; that said leases are valid and subsisting leases on the lands above described, and all rentals and royalties due thereunder have been paid and all conditions necessary to keep the same in force have been duly performed; and assignors hereby surrender and release all rights of dower and homestead in the premises above described.

Executed this 23rd day of December, 1946.

T. W. George, (Seal). Edmee May George, (Seal).

State of Illinois,
County of Wabash, ss:

I, J. K. Cline, a Notary Public, in and for said County in the State aforesaid, do hereby certify that T. W. George and Edmee May George, his wife, personally known to me to be the same persons whose names are subscribed to the

foregoing instrument, appeared before me this day in person, and acknowledged that they signed, sealed and [fol. 424] delivered said instrument as their free and voluntary act for the uses and purposes therein set forth, including the release and waiver of the right of homestead.

Given under my hand and Seal, this 23rd day of December, 1946.

J. K. Cline, Notary Public. (Notarial Seal)

Filed for record this the 2nd day of June, A. D. 1947, at 9:15 o'clock A. M.

R. E. Friend, Recorder.

[fol. 425] Exhibit F-6

Miscellaneous Gas and Oil Record No. 30

Assignment of Oil and Gas Lease

Know all men by these presents: That the undersigned T. W. George and Edmee May George, his wife, (hereinafter called Assignor), for and in consideration of One Dollar ($1.00) the receipt whereof is hereby acknowledged, does hereby sell, assign, transfer and set over unto T. W. George, John Wrather and F. B. Wimberly, DBA, George & Wrather Drilling Co. (hereinafter called Assignee), an undivided one-eighth (1/8) interest in and to the oil and gas lease dated June 3, 1946, from Martha Brown, a widow, Lessor, to Olen D. Sharp, Lessee, recorded in book 27, page 17, insofar as said lease covers the following described land in Wabash County, State of Illinois.

The North Half ($N^1/_2$) of the Southwest Quarter ($SW^1/_4$) and the South Half ($S^1/_2$) of the Northwest Quarter ($NW^1/_4$), all in Section One (1), Township Two (2) South, Range Fourteen (14) West, containing in all 160 acres, more or less.

This assigned interest is subject to and burdened with the one-half proportionate part of an overriding royalty interest heretofore reserved by Olen D. Sharp, entitling him to receive one-thirty-second (1/32) of seven-eights

(7/8) of all oil and gas hereinafter produced, saved and marketed from the above described lands under the terms of said lease, free and clear of all costs, together with the rights incident thereto and the personal property thereon, appurtenant thereto, or used or obtained in connection therewith.

And for the same consideration the Assignor covenants with the Assignee, its or his heirs, successors or assigns: That the Assignor is the lawful owner of and has good title to the interest above assigned in and to said lease, estate, rights and property, free and clear from all liens, encumbrances or adverse claims; That said lease is a valid and subsisting lease on the land above described, and all rentals and royalties due thereunder have been paid and all conditions necessary to keep the same in full force have been duly performed; and that the Assignor will warrant and forever defend the same against all persons whomsoever, lawfully claiming or to claim the same, and hereby surrenders and releases all rights of dower and homestead in the premises above described.

Executed, This 1st day of July, 1947.

T. W. George, (Seal), Edmee May George, (Seal).

State of Illinois,
County of Wabash, ss:

I, J. K. Cline, a Notary Public in and for the said County in the State aforesaid, Do Hereby Certify, That T. W. George and Edmee May George, his wife, personally known to me to be the same persons whose names are subscribed to the foregoing instrument, appeared before me this day in person, and acknowledged that they signed, sealed and delivered the said Instrument, including the release and waiver of the right of homestead, as their free and voluntary act, for the uses and purposes therein set forth.

Given under my hand and Notarial Seal; this 1st day of July, A. D., 1947. (Seal)

My Commission expires 10-21-1947.

J. K. Cline, Notary Public. (Notarial Seal)

Filed for Record the 21st day of August, A. D. 1947, at 8:50 o'clock A. M.

R. E. Friend, Recorder.

[fol. 426] Exhibit G-7

Oil Payment Agreement

Know All Men By These Presents:

That the undersigned

T. W. George, Edmee May George, John Wrather, Nell Wrather, Fred B. Wimberly and Virginia Wimberly, individually and doing business as "George & Wrather Drilling Company."

(hereinafter sometimes referred to as "George & Wrather"), for and in consideration of Ten Dollars ($10.00) and other valuable consideration, the receipt of which is hereby acknowledged, hereby agree and direct that

Indiana Farm Bureau Cooperative Association, Inc.

(hereinafter sometimes referred to as "COOP"), shall be paid the sum of One Hundred and Thirty Thousand Dollars ($130,000.00) the said sum to be paid out of the oil produced and saved from the lands hereinafter described, and to be 9/40 of 7/24 of 7/8 of all the oil produced and saved therefrom, until the full sum of One Hundred and Thirty Thousand Dollars ($130,000.00) shall have been paid to COOP.

The said payments shall be made out of the oil produced and saved from the following described real estate:

> The North half of the Southwest Quarter, and the South half of the Northwest Quarter, all lying in Section one (1), Township two (2) South, Range Fourteen (14) West, and containing 160 acres, more or less, Wabash County, Illinois.

which real estate is covered by the following described oil and gas leases:

> That certain Oil and Gas leases, executed by Martha D. Brown, widow, as Lessor to Olen D. Sharp, as Lessee, under date of June 3, 1946, the same being

recorded in Oil and Gas Lease Record 27, page 17 et seq. in the office of the Recorder of Wabash County, Illinois.

George & Wrather hereby direct that the aforesaid payments shall be paid directly to COOP by the purchaser of such oil, and COOP is hereby authorized to execute Division Orders necessary to effect such payment. This agreement, and payments made in accordance therewith, shall be effective as of June 1, 1948.

It is hereby stipulated and agreed that George & Wrather, and the individual partners thereof, shall have no personal liability by reason of this oil payment agreement. It is further stipulated and agreed that the said oil payment is secured by no other interest or lien other than as set out in this Agreement.

For the aforesaid consideration, George & Wrather covenent with COOP: That George & Wrather are the lawful owners of, and have good title to the interests out of which said oil is to be produced, free and clear from all liens, encumbrances or adverse claims, save and except those which may now or heretofore exist in favor of COOP; that the leases under which said oil is to be produced are valid and subsisting oil and gas leases on the lands herein described, and that all rentals and royalties due thereunder have been paid, and all conditions necessary to keep the same in full force have been duly performed.

George & Wrather hereby surrender and release all rights of dower and homestead insofar as they may effect the oil payment hereby created.

This Agreement shall be binding upon the heirs, successors and assigns of the undersigned.

[fol. 427] In witness whereof, we have set our hands and seals this 19th day of June, 1946. (8)

Edmee May George, (Seal), Nell Wrather, (Seal), Virginia Wimberly, (Seal), T. W. George, (Seal), John Wrather, (Seal), Fred B. Wimberly, (Seal).

individually and operating and doing business as George & Wrather Drilling Company (Seal)

By T. W. George, John Wrather, Fred B. Wimberly.

STATE OF TEXAS,
County of Gregg, ss:

I, the undersigned, a Notary Public, in and for said County, in the State aforesaid, do hereby certify that T. W. George and Edmee May George, his wife; John Wrather and Nell Wrather, his wife; Fred B. Wimberly and Virginia Wimberly, his wife, personally known to me appeared before me this day and acknowledged that they signed, sealed and delivered the said instrument as their free and voluntary act and deed for the uses and purposes therein set forth, including the release and waiver of the right of homestead and dower.

Given under my hand and seal this 19th day of June, 1946.

J. H. Walters, Notary Public.

My commission expires June 1, 1949.

STATE OF TEXAS,
County of Gregg, ss:

I, the undersigned, a Notary Public, in and for said County, in the State aforesaid, do hereby certify that T. W. George, John Wrather and Fred B. Wimberly, operating and doing business as George & Wrather Drilling Company personally known to me to be the same persons whose names are subscribed to the foregoing instruments, appeared before me this day in person, and acknowledged that they signed, sealed and delivered the said instruments as their free and voluntary act for the uses and purposes therein set forth, including the release and waiver of the right of homestead and dower.

Given under my hand and seal this 19th day of June, 1948.

J. H. Walters, Notary Public.

My commission expires June 1, 1949.

[fol. 428] EXHIBIT H

9442

Assignment of Oil and Gas Lease

Whereas heretofore, under date of October 16, 1947, Lawrence J. Kieffer and Anna Belle Kieffer, his wife, as Lessors, did execute and deliver to William E. Brubeck, as Lessee, an Oil and Gas Lease covering the following described lands situated in Gibson County, Indiana, to wit:

The West one-half ($\frac{1}{2}$) of the Southwest Quarter ($SW\frac{1}{4}$) of Section 25, Township 1 South, Range 12 West, containing 80 acres, more or less; said lease being recorded in Vol. 67 at page 349, of the records of said County;

And whereas heretofore, under date of October 16, 1947, Helen Postelnek, a widow, J. B. Whisenant and Mabel Whisenant, his wife, John W. Russell and Leona Russell, his wife, and Harry F. Corbin, Jr., and Sara Hyde Corbin, his wife, as Lessors, did execute and deliver to William E. Brubeck an Oil and Gas Lease covering the same premises above described, said lease being recorded in Vol. 67 at page 347, of the Records of Gibson County, Indiana;

And whereas heretofore under date of October 16, 1947, Lawrence J. Kieffer and Anna Belle Kieffer, his wife, as Lessors, did execute and deliver to William E. Brubeck, as Lessee, an Oil and Gas Lease covering the following described lands situated in Gibson County, Indiana, to wit:

All that part of the Southwest Quarter ($SW\frac{1}{4}$) of the Northwest Quarter ($NW\frac{1}{4}$) of Section 25, Township 1 South, Range 12 West, lying south of the Patoka River, containing 16 acres, more or less; said lease being recorded in Vol. 67 at page 351, of the records of said County;

Now, therefore, know all men by these presents, that the undersigned, William E. Brubeck and Ann Denton Brubeck, his wife, hereinafter called the Assignors, for and in consideration of Ten Dollars ($10.00) and other good and valuable considerations, the receipt whereof are hereby acknowledged, do hereby sell, assign, transfer and set over unto T. W. George, John Wrather and F. B. Wimberly, Partners, doing business as George & Wrather Drilling Company of Mt. Carmel, Illinois, hereinafter called Assignee, subject to the overriding royalty interest here-

inafter mentioned, an undivided five-sixteenths (5/16) interest in and to the three Oil and Gas Leases above described, together with the rights incident thereto.

This assignment is expressly made subject to an overriding royalty of one thirty second (1/32) of the leasehold seven eights (7/8) of all oil and gas produced and saved from said premises, the same having been created by an assignment from the Assignors herein to Ben H. Townsend and Joel W. Townsend dated November 24, 1947.

This assignment shall be effective as of November 1, 1947.

The terms hereof shall extend to and be binding upon the parties hereto, their heirs, legal representatives, successors and assigns; and the Assignors do hereby surrender and release all rights of dower and homestead in the premises above described.

In Witness Whereof we have hereunto set our hands and seals this 24th day of November, 1947.

William E. Brubeck (Seal), Ann Denton Brubeck (Seal).

STATE OF ILLINOIS,
County of Wabash, ss:

I, B. J. Walter, a Notary Public, in and for said County, in the State aforesaid, do hereby certify that William E. Brubeck and Ann Denton Brubeck, his wife, personally known to me to be the same persons whose names are subscribed to the foregoing instrument, appeared before me this day in person and acknowledged that they signed, sealed and delivered the said instrument as their free and voluntary act for the uses and purposes therein set forth, including the release and waiver of the right to homestead.

Given under my hand and Seal, this 24th day of November, 1947.

B. J. Walter, Notary Public. (N. P. Seal)

My commission expires Feb. 7, 1951.

Recorded December 1, 1947 at 2:00 P. M.,

Chas. W. Maxum, RGC

CERTIFICATE

STATE OF INDIANA,
County of Gibson, ss:

I, Charles L. Mans, Recorder of the County of Gibson, State of Indiana, do hereby certify that the foregoing is a true, correct and complete copy of the instrument as the same appears of record in my office in Book 68, Page 201.

Charles L. Mans, Recorder of Gibson County, Indiana.

[fol. 429] EXHIBIT I-9

Oil Payment Agreement

Know All Men By These Presents:

That the undersigned

T. W. George, Edmee May George, John Wrather, Nell Wrather, Fred B. Wimberly and Virginia Wimberly, individually and doing business as "George & Wrather Drilling Company",

(hereinafter sometimes referred to as "George & Wrather"), for and in consideration of Ten dollars ($10.00) and other valuable consideration, the receipt of which is hereby acknowledged, hereby agree and direct that

Indiana Farm Bureau Cooperative Association, Inc. (hereinafter sometimes referred to as "COOP") shall be paid the sum of One hundred and fifty-five thousand dollars ($155,000) the said sum to be paid out of the oil produced and saved from the lands hereinafter described, and to be 9/10 of 5/16 of 7/8 of all the oil produced and saved therefrom, until the full sum of One hundred and fifty-five thousand dollars ($155,000) shall have been paid to COOP.

The said payments shall be made out of the oil produced and saved from the following described real estate:

The Southwest Quarter ($SW^1/_4$) of Section twenty-five (25) Township one (1) South, Range twelve (12) West containing One Hundred Sixty (160) acres, more or less Gibson County, Indiana.

which real estate is covered by the following described oil and gas leases:

That Oil and Gas lease entered into between Helen Postelnak, widow, et al, as lessors, and William E. Brubeck, as lessee, dated October 16, 1947, and recorded in Lease Record Book 67, page 347, in the records of Gibson County, Indiana, and
that Oil and Gas lease entered into between Lawrence J. Kieffer and Anna Belle Kieffer, his wife, as lessors, and William E. Brubeck, as lessee, dated October 16, 1947, and recorded in Book 67, page 349, in the records of Gibson County, Indiana.
that Oil and Gas lease entered into between Lawrence J. Kieffer and Anna Belle Kieffer, his wife, as lessors, and William E. Brubeck, as lessee, dated December 23, 1947, and recorded in Book 67, page 561, in the records of Gibson County, Indiana, and
that Oil and Gas Lease entered into between Helen Postelnak, as lessor, and William E. Brubeck, as lessee, dated December 23, 1947, and recorded in Book 67, Page 471 in the records of Gibson County, and
that Oil and Gas Lease entered into between John W. Russell, et al, as lessors, and William E. Brubeck, lessee, dated December 29, 1947, and recorded in Book 67, Page 513, in the records of Gibson County, Indiana.

George & Wrather hereby direct that the aforesaid payments shall be paid directly to COOP by the purchaser of such oil, and COOP is hereby authorized to execute Division Orders necessary to effect such payment. This agreement, and payments made in accordance therewith, shall be effective as of June 1, 1948.

It is hereby stipulated and agreed that George & Wrather, and the individual partners thereof, shall have no personal liability by reason of this oil payment agreement. It is [fol. 430] further stipulated and agreed that the said oil payment is secured by no other interest or lien other than as set out in this Agreement.

For the aforesaid consideration, George & Wrather covenant with COOP: That George & Wrather are the lawful owners of, and have good title to the interests out of which said oil is to be produced, free and clear from all liens,

encumbrances or adverse claims, save and except those which may now or theretofore exist in favor of COOP; that the leases under which said oil is to be produced are valid and subsisting oil and gas leases on the lands herein described, and that all rentals and royalties due thereunder have been paid, and all conditions necessary to keep the same in full force have been duly performed.

George & Wrather hereby surrender and release all rights of dower and homestead insofar as they may effect the oil payment hereby created.

This Agreement shall be binding upon the heirs, successors and assigns of the undersigned.

In Witness Whereof, we have set our hands and seals this 19th day of June, 1948.

Edmee May George (Seal), Nell Wrather (Seal), Virginia Wimberly (Seal), T. W. George (Seal), John Wrather (Seal), Fred B. Wimberly (Seal).

Individually and operating and doing business as George & Wrather Drilling Company (Seal).

By T. W. George, John Wrather, Fred B. Wimberly.

STATE OF TEXAS,
County of Gregg, ss:

I, the undersigned, a Notary Public, in and for said County, in the State aforesaid, do hereby certify that T. W. George and Edmee May George, his wife; John Wrather and Nell Wrather, his wife; Fred B. Wimberly and Virginia Wimberly, his wife, personally known to me appeared before me this day and acknowledged that they signed, sealed and delivered the said instrument as their free and voluntary act and deed for the uses and purposes therein set forth, including the release and waiver of the right of homestead and dower.

Given under my hand and seal this 19 day of June, 1948.

J. H. Walters, Notary Public.

My commission expires June 1, 1949.

[fol. 431] STATE OF TEXAS,
County of Gregg, ss:

I, the undersigned, a Notary Public, in and for said County, in the State aforesaid, do hereby certify that T. W. George, and John Wrather and Fred B. Wimberly, operating and doing business as George & Wrather Drilling Company personally known to me to be the same persons whose names are subscribed to the foregoing instruments, appeared before me this day in person, and acknowledged that they signed, sealed and delivered the said instruments as their free and voluntary act for the uses and purposes therein set forth, including the release and waiver of the right of homestead and dower.

Given under my hand and seal this 19 day of June, 1948.

J. H. Walters, Notary Public.

My commission expires June 1, 1949.

[fol. 432] EXHIBIT J-10

Oil Payment Agreement

Know all men by these presents:

That the undersigned

T. W. George, Edmee May George, John Wrather, Nell Wrather, Fred B. Wimberly and Virginia Wimberly, individually and doing business as "George & Wrather Drilling Company."

(hereinafter sometimes referred to as "George & Wrather"), for and in consideration of Ten Dollars ($10.00) and other valuable consideration, the receipt of which is hereby acknowledged, hereby agree and direct that

Indiana Farm Bureau Cooperative Association, Inc.
(hereinafter referred to sometimes as "COOP")

shall be paid the sum of Twelve Thousand Five Hundred Dollars ($12,500.00), the said sum to be paid out of the oil produced and saved from the lands hereinafter described, and to be 9/10 of 5/16 of 7/8 of all the oil produced and

saved therefrom, until the full sum of Twelve Thousand Five Hundred Dollars ($12,500.00) shall have been paid to COOP.

The said payments shall be made out of the oil produced and saved from the following described real estate:

> The Southwest Quarter (SW^1_4) of the Section twenty five (25), Township one (1) South, Range twelve (12) West, containing One Hundred Sixty (160) acres, more or less, Gibson County, Indiana

which real estate is covered by the following described Oil and Gas Leases:

> That Oil and Gas Lease entered into between Helen Postelnak, widow, et al, as Lessors, and William E. Brubeck, as leasee, dated October 16, 1947, and recorded in Lease Record Book 67, page 347, in the records of Gibson County, Indiana, and
>
> that Oil and Gas Lease entered into between Lawrence J. Kieffer and Anna Belle Kieffer, his wife, as lessors, and William K. Brubeck, as lessee, dated October 16, 1947, and recorded in Book 67, page 349, in the records of Gibson County, Indiana, and
>
> that Oil and Gas lease entered into between Lawrence J. Kieffer and Anna Belle Kieffer, his wife, as lessors, and William E. Brubeck, as lessee, dated December 23, 1947, and recorded in Book 67, page 561, in the records of Gibson County, Indiana, and
>
> that Oil and Gas Lease entered into between Helen Postelnak, as lessor, and William E. Brubeck as lessee, dated December 23, 1947, and recorded in Book 67, page 471, in the records of Gibson County, Indiana, and
>
> that Oil and Gas lease entered into between John W. Russell (et al, as lessors, and William E. Brubeck, as lessee, dated December 29 1947, and recorded in Book 67, page 513, in the records of Gibson County, Indiana.

George & Wrather hereby direct that the aforesaid payments shall be paid directly to COOP by the purchaser of such oil, and COOP is hereby authorized to executed Divi-

sion Orders necessary to effect such payment." This agreement, and payments made in accordance therewith, shall be effective as of August 1, 1948.

It is hereby stipulated and agreed that George & Wrather, and the individual partners thereof, shall have no [fol. 433] personal liability by reason of this oil payment agreement. It is further stipulated that the said oil payment is secured by no other interest or lien other than as set out in this agreement.

For the aforesaid consideration, George & Wrather covenant with COOP: That George and Wrather are the lawful owners of, and have good title to the interests out of which said oil is to be produced, free and clear from all liens, encumbrances or adverse claims, save and except those which may now or heretofore exist in favor of COOP; that the leases under which said oil is to be produced are valid and subsisting oil and gas leases on the lands herein described, and that all rentals and royalties due thereunder have been paid, and all conditions necessary to keep the same in full force have been duly performed.

George & Wrather hereby surrender and release all rights of dower and homestead in so far as they may effect the oil payment hereby created.

This Agreement shall be binding upon the heirs, successors and assigns of the undersigned.

In Witness Whereof, we have set our hands and seals this 16th day of August, 1948.

Edmee May George (Seal), Nell Grather (Seal), Virginia Wimberly (Seal), T. W. George (Seal), John Wrather (Seal), Fred B. Wimberly (Seal).

Individually and operating and doing business as George & Wrather Drilling Company (Seal).

By T. W. George.

STATE OF,

County of, ss:

I, the undersigned, a Notary Public, in and for said County, in the State aforesaid, do hereby certify that T. W. George and Edmee May George, his wife; John Wrather and Nell Wrather, his wife; Fred B. Wimberly and Virginia Wimberly, his wife, personally known to me appeared

before me this day and acknowledged that they signed, sealed and delivered the said instrument as their free and voluntary act and deed for the uses and purposes therein set forth, including the release and waiver of the right of homestead and dower.

Given under my hand and seal this day of August, 1948.

Notary Public.

My commission expires:

[fol. 434] State of,
County of, ss:

I, the undersigned, a Notary Public, in and for said County, in the State aforesaid, do hereby certify that T. W. George, John Wrather and Fred B. Wimberly, operating and doing business as George & Wrather Drilling Company, personally known to me to be the same persons whose names are subscribed to the foregoing instrument, appeared before me this day in person, and acknowledged that they signed, sealed and delivered the said instrument as their free and voluntary act for the uses and purposes therein set forth, including the release and waiver of the right of homestead and dower.

Given under my hand and seal this day of August, 1948.

Notary Public.

My commission expires:

[fol. 435] Minute Entry of Argument and Submission—December 3, 1956

(Omitted in Printing)

[fol. 436] IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 16055

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

versus

JOHN WRATHER AND NELL WRATHER, Husband and Wife, Respondents.

Petition for Review of Decision of the Tax Court of the United States (District of Texas).

OPINION—February 1, 1957

Before Hutcheson, Chief Judge, and Holmes and Borah, Circuit Judges.

HUTCHESON, *Chief Judge:* This appeal from an unreported decision of the Tax Court on stipulated facts,[1]

[1] Briefly and adequately stated, they are:

In 1948 the George & Wrather Drilling Company, a Partnership, of which the taxpayer, John Wrather, was a member, sold and conveyed to the Indiana Farm Bureau Cooperative Association, Inc. (herein called COOP) three oil payments carved out of their interests in two oil and gas leases which had been held by the partnership for more than six months. One was for $130,000, payable out of 9/10 of 7/24 of 7/8 of all of the oil produced and saved from the Brown Lease; the others were for $155,000 and $12,500, respectively, payable out of 9/10 of 5/16 of 7/8 of all of the oil produced and saved from the Kieffer "A" Lease.

As consideration for these assignments, COOP paid the partnership $287,500 cash which was treated by the partners on their tax returns as gain from the sale of capital assets. The oil payment out of the Brown Lease paid out in a period of 4 years and the oil payments out of the Kieffer "A" Lease paid out in a period of 5 years 5 months.

[fol. 437] and findings by the Tax Court in favor of respondents, presents the single question whether the Tax Court erred in holding that taxpayer John Wrather's share of the proceeds received from the sale by a partnership, of which he was a member, of oil payments carved out of leasehold estates owned and operated by it was long term capital gain under Sec. 117, rather than ordinary income subject to depletion.

Here the Commissioner advances the same contentions and arguments which, at greater length, he advanced in *Commissioner* v. *Lake and Fleming* & *Commissioner*, this day decided, while the respondents here oppose to them substantially the same contentions and arguments advanced by the respondents in those cases.

Referring to, without restating the considerations upon, and the reasons for, which, rejecting the commissioner's, and sustaining the taxpayer's, contentions, we conclude that those cases had been correctly decided below, it is sufficient for us to hold that, upon those same considerations and for the same reasons, we conclude that this [fol. 438] case was correctly decided and that the decision and order appealed from should be Affirmed.

[fol. 439] In the United States Court of Appeals for the Fifth Circuit

No. 16055

Commissioner of Internal Revenue,

versus

John Wrather and Nell Wrather, Husband and Wife

Judgment—February 1, 1957

This cause came on to be heard on the petition of Commissioner of Internal Revenue for a review of a decision of The Tax Court of the United States, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court that the decision and

order of the said Tax Court appealed from in this cause be, and the same is hereby, affirmed.

[fol. 440] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 441] [Caption omitted.]

[fol. 442] IN THE TAX COURT OF THE UNITED STATES

Docket No. 46312

W. F. WEED, Individual and Estate of Eleanor M. Weed, Deceased—W. F. Weed, Executor, Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent.

APPEARANCES

For Petitioner: Peter B. Wells, Esq.
For Respondent: W. B. Riley, Esq.

DOCKET ENTRIES

1953

Jan. 8—Petition received and filed. Taxpayer notified. Fee paid.

Jan. 8—Copy of petition served on General Counsel.

Feb. 25—Answer filed by General Counsel.

Feb. 25—Request for hearing in Houston, Texas filed by General Counsel.

Mar. 3—Notice issued placing proceeding on Houston, Texas calendar. Service of answer and request made.

[fol. 443] 1954

Jan. 15—Hearing set April 5, 1954, Galveston, Texas.

Mar. 29—Motion for continuance filed by taxpayer. 3-31-54 Granted.

Jul. 20—Hearing set October 25, 1954, Houston, Texas.

1954

Nov. 1—Hearing had before Judge Black, on merits, petitioner's oral motion to amend petition, denied, oral motion of petitioner to take deposition of J. P. LaFour, granted. Entry of appearance of Peter B. Wells, filed. Petitioner's brief due January 3, 1955. Respondent's brief due February 3, 1955. Petitioner's reply brief due March 1, 1955.

Dec. 28—Transcript of hearing 11 1 54 filed.

Dec. 30—Motion for extension to February 14, 1955 to file petitioner's brief March 16, 1955 to file answering brief, and April 15, 1955 to file reply brief filed by taxpayer 12 30 54 Granted.

1955

Feb. 14—Motion for extension to February 18, 1955 to file brief and to March 21, 1955 to file respondent's answering brief filed by taxpayer. 2 15 55 Granted.

Feb. 17—Brief filed by taxpayer. 2 18 55 Copy served.

Mar. 15—Motion for extension to May 5, 1955 to file answering brief filed by General Counsel. 3 16 55 Granted.

Apr. 18—Motion for extension to June 13, 1955 to file answering brief filed by General Counsel. 4 19 55 Granted.

Jun. 13—Motion for extension to June 29, 1955 to file answering brief filed by General Counsel. 6 14 55 Granted.

[fol. 444] Jun. 29—Motion for extension to July 13, 1955 to file brief filed by General Counsel. 7 1 55 Granted.

Jul. 8—Answer brief filed by General Counsel. Served 7 11 55.

Aug. 16—Motion for extension to August 31, 1955 to file reply brief filed by taxpayer. 8 16 55 Granted.

Aug. 29—Motion for extension to September 16, 1955 to file reply brief filed by taxpayer. 8 29 55 Granted.

Sept. 15—Reply brief filed by taxpayer. Copy served.

Sept. 22—Findings of fact and opinion filed, Black, Judge. Decision will be entered under Rule 50. Copy served.

Dec. 13—Agreed computation filed.

Dec. 14—Decision entered, Judge, Black.

1956

Mar. 6—Petition for review by United States Court of Appeals, Fifth Circuit, with assignments of error filed by respondent.

Mar. 20—Proof of service of petition for review filed. (W. F. Weed).

Mar. 20—Proof of service of petition for review filed. (Peter B. Wells, Esq.)

Mar. 20—Proof of service of petition for review filed. (Estate of Eleanor M. Weed, Deceased, W. F. Weed, Executor).

Apr. 20—Motion for extension of time to 7 5 56 to prepare, transmit and dvliver the record on review filed by respondent.

Apr. 26—Order extending time to 7 5 56 to prepare, transmit and deliver the record on review, entered.

[fol. 445] May 7—Certified copy of order of Court of Appeals, Fifth Circuit, directing the original exhibits and original official report of proceedings at Houston, Texas, on November 1, 1954, be made part of the transcript of record filed.

May 9—Agreed praecipe for record filed.

In The Tax Court of the United States

Docket No. 46312

W. F. Weed, Individual and Estate of Eleanor M. Weed, Deceased—W. F. Weed, Executor, Petitioners,

versus

Commissioner of Internal Revenue, Respondent.

Petition—Filed and received January 8, 1953

Prepared by Taxpayer: W. F. Weed, P. O. Box 2390, Beaumont, Texas.

[fol. 446] The petitioners, W. F. Weed, individually and W. F. Weed as Executor for the Estate of Eleanor M. Weed (Deceased) hereby petition for a redetermination of

the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency, Bureau symbols IRA: 90D-H, dated October 24, 1952, and as a basis of the proceeding allege as follows:

1. The petitioners were husband and wife, residing in Beaumont, Jefferson County, Texas during the entire calendar years 1948 and 1949. The wife dies on August 3, 1952 and the husband qualified as Executor for her estate (see Exhibit B attached) on October 22, 1952, being case number 13489 of the Probate Court, Jefferson County, Texas. The mailing address is P. O. Box 2390, Beaumont, Texas. The petitioners filed joint income tax returns for the calendar years 1948 and 1949 with the Collector of Internal Revenue, Austin, Texas.

[fol. 447] 2. The notice of deficiency, a copy of which is attached and marked "Exhibit A", was mailed to the petitioners on or after October 24, 1952.

3. According to the notice of deficiency, the Commissioner has determined an income tax deficiency against the petitioners for the calendar year 1948 in the amount of $4,136.79. Approximately $3,871.78 of this deficiency is in dispute in this proceeding, and approximately $265.01 of the deficiency is not contested. The Commissioner has also determined a deficiency for the calendar year 1949 in the amount of $1,055.76, all of which is in dispute.

4. Assignment of Error

The determinations set forth in the notice of deficiency are based upon the following errors:

I. The commissioner erred in disallowing long term capital gains treatment on the sale of sulphur in place in the ground.

5. Statement of Facts

The facts upon which the petitioners rely as the basis of this proceeding are as follows:

(1) The husband acquired on or before December 31, 1945, certain royalty interests in sulphur at Boling Dome, Wharton County, Texas, the extraction of which is covered by lease with the Texas Gulf Sulphur Company.

[fol. 448] (2) The installment sale in dispute was made on December 24, 1947. A copy of this sale is attached and has been marked "Exhibit C".

(3) An interest in sulphur in place in the ground comes within the scope of Section 117 of the Internal Revenue Code as being a capital asset.

(4) Since the sale in dispute was a capital asset under Section 117 of the Internal Revenue Code, and was owned for more than six months, the gain or loss on the sale thereof is covered by Section 117(b) of the Internal Revenue Code.

(5) The Commissioner's disallowance of Section 117 treatment on this sale as evidenced by an Internal Revenue Agent's report dated October 3, 1951, was based on *GCM 24849* (C. B. 1946-1, 66) and *IT 4003* (C. B. 1950-1, 10). Both GCM 24849 and IT 4003 refer specifically to oil and gas and neither refers in any way to any other minerals; therefore, the application of these two rulings must be restricted to oil and gas transactions only.

Wherefore, petitioners pray that this court hear this proceeding; disallow the deficiencies complained of, and issue an order of redetermination correctly determining pe-[fol. 449] titioners income tax liability for the calendar years 1948 and 1949.

W. F. Weed, Individual, W. F. Weed, Executor for the Estate of Eleanor M. Weed, P. O. Box 2390, Beaumont, Texas.

Duly sworn to by W. F. Weed, jurat omitted in printing.

[fol. 450] EXHIBIT A TO PETITION

DALLAS
IRA:90D-H

Statement

Mr. W. F. Weed, and Mrs. Eleanor M. Weed, Husband and Wife

P. O. Box 2390, Beaumont, Texas

Income Tax Liability for the Taxable Years Ended December 31, 1948 and 1949

Year	Deficiency
1948	$ 4,136.79
1949	1,055.76
Total	$ 5,192.55

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated August 23, 1951; to your protest executed October 31, 1951; and to the statements made at the conference held on December 13, 1951 and July 22, 1952.

It is held that the consideration received by you for the assignment of a sulphur payment to Marion F. Munro is ordinary income subject to the depletion allowance. The amount of $16,300.00 received by you in each of the years 1948 and 1949, therefore, has been included in ordinary in-[fol. 451] come and 23% thereof, or $3,749.00, has been allowed as depletion in each of those years, and the amounts of $7,845.56 and $7,845.55 reported by you as capital gains upon the transaction in the respective years 1948 and 1949 have been eliminated from your taxable income.

A copy of this letter and statement has been mailed to your representative, Mr. Marion F. Munro, 1020 Goodhue Building, Beaumont, Texas, in accordance with the authority contained in the power of attorney executed by you and on file in this office.

Taxable Year Ended December 31, 1948

Adjustments to Net Income

Net income as disclosed by joint return		$51,680 30
Unallowable deductions and additional income:		
(a) Disallowed as nontaxable capital gain	$1,242 52	
(b) Income from sulphur royalty	12,551 00	
(c) Net loss not deductible in 1948	2,372 01	
Total	$16,165 53	
[fol. 452]		
Additional deductions:		
(d) Capital gain decreased	$7,845 56	
(e) Casualty loss increased	633 56	
(f) Depletion on patents	73 53	
(g) Contributions	25 00	
Total	$8,577 65	
Net addition		7,587 88
Net income adjusted		$59,268 18

Explanation of Adjustments

(a) The net long-term capital losses reported have been reduced by the amount shown as deductible loss on account of worthlessness of stock of Moor-Kelly Development Corporation, which was not proved worthless in 1948, and by the part of the loss claimed on bonds of the City of Opelousas, Louisiana, which was due to the premium paid at purchase and which should have been amortized over the life of the bonds. Adjustments are:

Loss claimed and disallowed on stock	$ 1,162.52
Amount of loss claimed due to premium on bond, 50% of $160.00	80.00
Total	$ 1,242.52

(b) As stated above the amount received for the assignment of a sulphur payment less 23% depletion is included in full in income. See item (d) for reduction of capital gain.

[fol. 453] Amount received	$ 16,300.00
Less: Depletion, 23%	3,749.00
Amount taxable	$ 12,551.00

(c) Adjustments herein to net capital gains and losses reported resulted in a net short-term capital loss of $3,372.01. Since only $1,000.00 is allowable as a deduction in 1948, the remainder of $2,372.01, is to be carried over to 1949. The amount is determined as follows:

Net short-term capital loss per return		$8,121.67
Long-term capital gains per return	$7,256.08	
Long-term capital loss disallowed (a)	1,242.52	
Long-term capital gain eliminated (d)	(7,845.56)	
Long-term capital gain eliminated (e)	(344.36)	
Net amount		308.68
Net capital loss		$7,812.99
Plus capital gains and losses from fiduciaries—$8,881.96—Amount recognized—50%		4,449.98
Net capital loss		$3,372.01
Amount allowable in 1948		1,000.00
Disallowed for 1948		$2,372.01

[fol. 454] (d) The amount of long-term capital gain reported on the sulphur payment, $7,845.56, is eliminated here since the amount taxable is included in full in item (b) above.

(e) Loss from a casualty less gain on the sale of a business car is allowed as a deduction under section 117(j)(2) of the Internal Revenue Code, as follows:

Loss due to rain damage on residence	$ 1,322.27
Gain from sale of car	688.71
Net amount deductible	$ 633.56

(f) Depletion on a patent, $73.53, was omitted from the total of depletion in the return and is, therefore, deducted here.

(g) Contributions of $25.00 made by Mrs. Weed were omitted from the return and are allowed here.

Computation of Tax

Net income as corrected	$ 59,268.18	
Less: Exemptions (4 x $600.00)	2,400.00	
Income subject to tentative tax	$ 56,868.18	
½ of $56,868.18—joint return	$ 28,434.09	
Tentative tax	$ 12,249.14	(1)
[fol. 455] Tax reduction: $68.00 plus 12% of $11,849.14	1,489.90	(2)
Combined normal tax and surtax, (1) minus (2)	$ 10,759.24	
Multiply $10,759.24 by 2 for tax liability	$ 21,518.48	
Income tax liability disclosed by return—Account No. 9128679	17,381.69	
Deficiency in income tax	$ 4,136.79	

Taxable Year Ended December 31, 1949

Adjustments to Net Income

Net income as disclosed by joint return		$33,555.27
Unallowable deductions and additional income:		
(a) Income from sulphur royalty	$12,551.00	
(b) Medical expense deduction	116.67	
Total	$12,667.67	
Nontaxable income and additional deductions:		
(c) Capital gain decreased [fol. 456]	$7,845.55	
(d) Capital loss carry-over from 1948	2,372.01	
Total	$10,217.56	
Net addition		2,450.11
Net income adjusted		$36,005.38

Explanation of Adjustments

(a) Received for assignment of a sulphur payment, as above	$ 16,300.00
Less: 23% depletion	3,749.00
Net addition to taxable income	$ 12,551.00

(b) Medical expense has been adjusted to give effect to adjustments above as follows:

Amount of medical expenses		$2,972.74
Less: 5% of adjusted gross income:		
Adjusted gross income per return	$37,139.63	
Plus (a), minus (b) and (c)	2,333.44	
Total	$39,473.07	
5% of $39,473.07		1,973.65
Deduction allowable		$999.09
Amount deducted per return		1,115.76
Excessive deduction		$116.67

[fol. 457] (c) The amount, $7,845.55, reported as taxable long-term capital gain on the sulphur payment is eliminated here because the gain is included in full in item (a) above.

(d) The capital net loss carry-over from 1948 (see adjustment (c) for 1948 above) is allowed as a deduction.

Computation of Tax

Net income as corrected	$ 36,005.38	
Less: Exemptions (4 x $600.00)	2,400.00	
Income subject to tentative tax	$ 33,605.38	
½ of $33,605.38—joint return	$ 16,802.69	
Tentative tax	$ 5,601.35	(1)
Tax reduction:		
$68.00 plus 12% $5,201.35	692.16	(2)
Combined normal tax and surtax, (1) minus (2)	$ 4,909.19	
Multiply $4,909.19 by 2 for tax liability	$ 9,818.38	
Income tax liability disclosed by return—Account No. 9079305	8,762.62	
Deficiency in income tax	$ 1,055.76	

[fol. 458] Exhibit C to Petition

The State of Texas,
County of Wharton:

Whereas, the undersigned, W. F. Weed, of Jefferson County, Texas is the owner of a pooled royalty on sulphur

produced from Boling Dome, Wharton County, Texas, by Texas Gulf Sulphur Company, amounting to $.00966133 per long ton, which royalty was acquired by W. F. Weed through deeds as follows, to wit:

[fol. 459] 1. Deed from Jas. F. Weed, et ux, to Mary Weed Fletcher, et al, dated 9-1-33, conveying pooled royalties of $.005015 and $.001469, recorded in Vol. 105, page 395, Deed Records of Wharton County, Texas one third (1/3) to W. F. Weed.

2. Deed from Jas. F. Weed, et ux, to Mary Weed Fletcher, et al, dated 8-15-35, conveying pooled royalty of $.01500, recorded in Vol. 117, page 347, Deed Records of Wharton County, Texas, one-third (1/3) to W. F. Weed.

3. Deed from Cora Louise Weed, W. F. Weed and Will E. Orgain, Independent Executors of the Estate of Jas. F. Weed, Deceased, to Cora L. Weed, et al, dated 8-1-45, conveying pooled royalty of $.04500, recorded in Vol. 180, page 21, Deed Records, Wharton County, Texas one-sixth (1/6) to W. F. Weed.

4. Deed from W. F. Weed to T. E. Moor, dated 12-28-45, conveying pooled royalty of $.00500 of record in Vol. 183, page 369, Deed Records, Wharton County, Texas.

Now, Therefore, Know All Men by These Presents, that I, W. F. Weed, in consideration of the sum of Thirteen Thousand Nine Hundred ($13,900.00) Dollars in cash in hand to me paid by Marion F. Munro, of Jefferson, County, Texas, receipt of which is hereby acknowledged, and the execution and delivery by Marion F. Munro, of two promissory notes of even date hereof, payable to W. F. Weed, [fol. 460] and each of said notes being in the sum of Sixteen Thousand Three Hundred ($16,300.00) Dollars, and due respectively one and two years after date and bearing interest after maturity at the rate of six per cent (6%) per annum, do hereby Sell, Transfer and Assign, unto the said Marion F. Munro, of Jefferson County, Texas, 86.254514% of $.00966133 per long ton pooled royalty on sulphur produced by Texas Gulf Sulphur Company at Boling Dome, Wharton County, Texas, from lands and premises described in said above named conveyances, until six million (6,000,000) long tons of sulphur have been produced and accounted for to the said Marion F. Munro

therefrom, which royalty so sold and here assigned and conveyed amounts to $.00833333 per long ton.

To Have and to Hold said percent per long ton pooled royalty on sulphur so produced, together with all and singular the rights and appurtenances thereto belonging unto the said Marion F. Munro, his heirs, administrators and assigns.

This assignment and the royalty transferred and assigned hereby on sulphur produced from Boling Dome, Wharton County, Texas, by Texas Gulf Sulphur Company to be paid to Marion F. Munro shall continue and be effective until said Marion F. Munro shall have received said royalty on six million (6,000,000) long tons of sulphur and no longer. Due to the way and manner sulphur royalties are paid, the royalty for sulphur produced in the year 1947, to and through December 31, 1947, shall be paid to W. F. Weed, and said sulphur royalties covering sulphur produced on and after January 1, 1948, shall be paid to Marion F. Munro [fol. 461] until he has received said royalty on said six million (6,000,000) long tons of sulphur.

In Witness Whereof I have hereunto set my hand for seal this 24th day of December, 1947.

(Signed) W. F. Ford.

The State of Texas,
County of Jefferson:

Before me, the undersigned authority, on this day personally appeared W. F. Weed, known to me to be the person whose name is subscribed to the foregoing instrument, and acknowledged to me that he executed the same for the purposes and consideration therein expressed.

Given under my hand and seal of office this 26th day of December, A. D., 1947.

(Signed) Billy Blanton, Notary Public in and for Jefferson County, Texas.

[fol. 462] IN THE TAX COURT OF THE UNITED STATES

[Title omitted]

ANSWER Filed February 25, 1953

Comes now the Commissioner of Internal Revenue, by his attorney, Charles W. Davis, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed in this proceeding admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the notice of deficiency was mailed to the petitioners on October 24, 1952; but denies the remaining allegations contained in paragraph 2 of the petition.

3. Admits in the notice of deficiency, the Commissioner has determined an income tax deficiency against the petitioners for the calendar year 1948 in the amount of $4,136.79; that the Commissioner has also determined a deficiency for the calendar year 1949 in the amount of $1,055.76, all of which is in dispute. Denies the remaining allegations contained in paragraph 3 of the petition.

[fol. 463] 4 I. Denies that the respondent erred in the manner alleged in subparagraph I of paragraph 4 of the petition.

5. (1) Admits the allegations contained in subparagraph (1) of paragraph 5 of the petition.

(2) to (4) incl. Denies the allegations contained in subparagraphs (2) to (4), inclusive, of paragraph 5 of the petition.

(5) Admits the Commissioner's disallowance of a sale is based in part on GCM 24849 (C. B. 1946-1, 66) and IT 4003 (C. B. 1950-1, 10); but denies the remaining allegations contained in subparagraph (5) of paragraph 5 of the petition.

Denies generally and specifically each and every allegation contained in the petition not hereinbefore expressly admitted, qualified or denied.

Wherefore, it is prayed the determination of the Commissioner be approved.

Charles W. Davis, FSG, Chief Counsel, Bureau of Internal Revenue.

Of Counsel: James L. Backstrom, District Counsel, Allen [fol. 464] T. Akin, Appellate Counsel, Joseph P. Crowe, Special Attorney, Bureau of Internal Revenue, 316 Federal Land Bank Building, Houston, Texas.

In The Tax Court of The United States

[Title omitted]

24 T. C. No. 116

Findings of Fact and Opinion—Filed: September 22, 1955

Held, the gain resulting from W. F. Weed's sale and transfer of a sulphur payment carved out of his pooled royalty interests in sulphur produced from deposits in place, which interests Weed had owned for several years prior to the date of sale, was taxable as long-term capital gain on the installment basis and not as ordinary income.

[fol. 465] Peter B. Wells, Esq., for the petitioners.
W. B. Riley, Esq., for the respondent.

The Commissioner has determined deficiencies in petitioners' income taxes as follows:

Year	Deficiency
1948	$ 4,136.79
1949	1,055.76

(Seal.)

The deficiency for 1948 is due to the following adjustments:

(a) Disallowed as non-taxable capital gain	$ 1,242.52
(b) Income from sulphur royalty	12,551.00
(c) Net loss not deductible in 1948	2,372.01

Adjustment (b), which is the principal adjustment, is described in the deficiency notice as follows:

> (b) As stated above the amount received for the assignment of a sulphur payment less 23% depletion is included in full in income. See item (d) for reduction of capital gain.
>
> | | |
> |---|---|
> | Amount received | $16,300.00 |
> | Less: Depletion, 23% | 3,749.00 |
> | Amount taxable | $12,551.00 |

[fol. 466] The petition assigns error only as to adjustment (b) described above. The assignment of error is as follows:

> I. The commissioner erred in disallowing long-term capital gains treatment on the sale of sulphur in place in the ground.

The deficiency for 1949 is based principally upon an adjustment of the same kind and in the same amount as adjustment (b) for 1948, and the assignment of error is the same for 1949 as for 1948. There is also an adjustment for 1949 of $116.67 for disallowance of medical expenses but counsel stated at the hearing that that will be automatically taken care of when we decide the main adjustment in the case.

Findings of Fact

W. F. Weed, sometimes hereinafter referred to as petitioner, resires in Beaumont, Texas. Eleanor M. Weed was petitioner's wife during the tax years 1948 and 1949, and at all other times pertinent hereto. She died testate on August 3, 1952, whereupon, by order of the Probate Court

(Seal.)

of Jefferson County, Texas, petitioner was appointed independent executor of her estate. He has continued as such to the date of this hearing.

Petitioner and his wife filed joint income tax returns for 1948 and 1949 with the collector of internal revenue, Austin, Texas.

[fol. 467] In 1945 and 1946, as principal stockholder, petitioner formed two companies, Pre-Fab Building Supply Corporation, and Star Lumber Company, and also formed, as a wholly owned subsidiary of the latter, Planet Lumber Corporation. In 1947, these companies were in need of funds and were not sufficiently sound financially to have adequate credit. In addition, petitioner contemplated the organization of another corporation whose capital requirements would exceed $100,000. Such corporation was actually formed in May 1948, and petitioner did supply most of its capital.

Petitioner in 1947 believed that, in 1948 and the succeeding years, he would need all (or a large part) of the credit which was available to him personally at the banks or through similar sources to obtain funds for use in the carrying on of the aforementioned business enterprises. He, therefore, desired some assurance that he would have a definite source of funds (other than banks and similar sources) for payment of his individual Federal income taxes due in those later years.

On December 23, 1947, petitioner was the owner of a pooled overriding royalty interest in sulphur produced by the Texas Gulf Sulphur Company from a tract of land referred to as Boling Dome, in Wharton County, Texas.[1] Petitioner's royalty interest entitled him to receive $.0096613 [fol. 468] per long ton of sulphur produced from Boling Dome by the aforementioned company, irrespective of what the market price for such sulphur might be. Royalty payments were made by the company monthly, based on the previous month's production. Petitioner's $.0096613 per long ton interest represented the aggregate of three pooled royalty interests, each in a lesser amount, received by petitioner (a) from his father by two *inter vivos* deeds dated

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[1] The Boling Dome tract was composed of a number of parcels of land. The owners of the royalty interests in sulphur produced from each of those individual parcels entered into a pooling agreement pursuant to which royalties from sulphur produced anywhere in Boling Dome were to be distributed pro rata among all such royalty interest holders. Thus, petitioner's interest is referred to as "pooled."

September 1, 1933 and August 15, 1935, respectively, and (b) after his father's death, from the latter's estate by independent executor's deed dated August 1, 1945. Such interest was not held by petitioner primarily for sale to customers in the ordinary course of his trade or business.

In the summer or early fall of 1947, petitioner, Frank C. Taylor (a C.P.A. then retained as accountant for petitioner's personal affairs and who prepared petitioner's 1947 return), and Marion Munro (a C.P.A. then retained by two of petitioner's corporations and who subsequently prepared petitioner's individual joint returns for 1948 and 1949) discussed the problem of petitioner's business commitments and the need for providing some sure source of funds with which to pay petitioner's individual income taxes, especially those due in January 1948. It was suggested that petitioner might sell a portion of his Boling Dome royalty interests, and Munro expressed the opinion that such a transaction would have the advantage of being taxed to petitioner at capital gain rates. Munro indicated a probable willingness to purchase a portion of that royalty interest and negotiations followed.

Petitioner and Munro discussed the amount of money petitioner would probably need in later years to pay his taxes, [fol. 469] the probable amount of sulphur still in place (which they estimated to be about 45 million tons), the anticipated annual rate of sulphur production, the annual royalty payments which would probably be received by a purchased of petitioner's interest, the probable amount of time required for pay-outs from sulphur production of different sums of money, the discount factor (such as the interest Munro would have to pay on funds borrowed by him to purchase the royalty interest) which affected Munro's profit from the transaction, and the tax savings to petitioner.

It was finally agreed that the transaction would be based upon petitioner's anticipated requirements for funds to pay taxes for the succeeding three years, and upon a four-year pay-out period from sulphur production to Munro. On this basis, it was determined that petitioner would assign to Munro a portion of his royalty interest on 6,000,000 long tons of sulphur, from which Munro would receive $50,000 within about four years, and that, in return, Munro would

pay petitioner $46,500 over a three-year period. Munro advised petitioner that the latter's tax savings resulting from the transaction would be about $4,000 to $4,500 and Munro estimated that his own profit from the transaction (after allowance for the discount factor) would approach $2,000.

On December 24, 1947, petitioner executed a deed conveying to Munro 86.254514 per cent of his pooled royalty interest of $.00966133 (i.e., $.00833333) per long ton on 6,000,000 long tons of sulphur to be produced from Boling Dome. In consideration therefor Munro gave petitioner:

[fol. 470] Check dated 12 24 47	$13,900
Promissory note due 12 24 48 (with 6% annual interest after maturity)	16,300
Promissory note due 12 24 49 (with 6% annual interest after maturity)	16,300
	$46,500

Pertinent portions of the assignment follow:

I, W. F. Weed, in consideration of [$13,900 cash and the two $16,300 notes] * * *, do hereby Sell, Transfer and Assign, unto the said Marion F. Munro, * * * 86.254514% of $.00966133 per long ton pooled royalty on sulphur produced by Texas Gulf Sulphur Company at Boling Dome, Wharton County, Texas, from lands and premises described in said above named conveyances [to petitioner from his father and his father's estate], until six million (6,000,000) long tons of sulphur have been produced and accounted for to the said Marion F. Munro therefrom, which royalty so sold and here assigned and conveyed amounts to $.00833333 per long ton.

* * * * * * *

This assignment and the royalty transferred and assigned hereby on sulphur produced from Boling Dome, * * * shall continue to be effective until said Marion F. Munro shall have received said royalty on six million (6,000,000) long tons of sulphur and no longer. * * *

[fol. 471]

The following statement shows the payments made by Munro to petitioner, pursuant to the above conveyances, and the method of financing used by Munro:

Date	Munro's payments to petitioner	Munro's loans from First National Bank, Beaumont, Texas: Amount	Annual Int.	Fully Paid By	Total Int. Paid
Dec. 24, 1947	$13,900	$13,900	4%	8/20/48	$224 41
Sept. 25, 1948	2,000				
Dec. 20, 1948	14,300	8,500	5%	5/19/49	95 14
Dec. 19, 1949		3,000	5%	2/20/50	18 19
Dec. 23, 1949	16,300				
Total	$46,500	$25,400			$337 74

[fol. 472] Munro's loans from the bank were negotiated by him independently of petitioner and were not guaranteed by petitioner. As security for the loans Munro assigned to the bank the royalty interest purchased from petitioner until such time as all his loans were paid. Concurrently with that assignment he notified the Texas Gulf Sulphur Company to make his royalty checks payable jointly to himself and the bank and to mail them directly to the bank. The bank credited the royalty checks received first to the principal and interest due on the above loans and, when that was satisfied, to Munro's personal account. Receipt of royalty checks from Texas Gulf Sulphur Company averaging about $2,000 each from February 28, 1948 until March 20, 1950 (on which date the limited royalty interest on 6,000,000 tons was fully paid out) resulted in its being unnecessary for Munro to borrow more than $11,500 in order to meet the two $16,300 notes due petitioner, since Munro was able to, in part, pay those notes at maturity with royalties received and accumulated prior thereto.

As above indicated the limited royalty interest which petitioner assigned Munro on December 24, 1947, was paid out within 28 months thereafter. In his income tax returns Munro reported the royalties he received as ordinary income, less cost depletion, in the year of receipt.

Petitioner used the $13,900 received from Munro on December 24, 1947, in paying the January 15, 1948 installment on his 1947 Federal income tax.

Separate individual Federal tax returns for 1947 were filed, on a community property basis, by petitioner and his

wife. The above transaction was fully disclosed in those [fol. 473] returns, was treated as resulting in capital gain, and the profits therefrom were reported on the installment basis. After adjustments for basis and costs of sale, the profit realized in 1947 from the $13,900 received that year was reported as $13,380.78. Fifty per cent thereof, $6,690.39, was taken into account as a community long term capital gain and petitioner and his wife each reported half of that sum ($3,345.19) as their community share in the separate returns they filed.

Petitioner and his wife filed joint income tax returns for both 1948 and 1949. In each of those years petitioner received from Munro, pursuant to the terms of the aforementioned transaction, $16,300. In their return for each year they reported, after adjusting the $16,300 for basis, a profit of $15,691.11 on the installment basis, and took 50 per cent thereof ($7,845.56) into account as long term capital gain.

OPINION

BLACK, *Judge:* Some of the adjustments made by the Commissioner in his determination of the deficiencies are not contested and these adjustments will be given effect in a recomputation under Rule 50.

The issues which we do have before us are common to both years. Petitioner states the issues in his brief as follows:

1. Whether the Commissioner erred in taxing to petitioner as ordinary income for the years 1948 and 1949 [fol. 474] proceeds from the 1947 sale of a sulphur royalty and whether such proceeds are long term capital gains and properly reported on the installment basis.

2. If it be determined that petitioner realized ordinary income from the sale of such sulphur royalty, whether all the proceeds should be reported as ordinary income for the year 1947.

The amounts which petitioner has received in each of the taxable years in return for the limited sulphur royalty (hereinafter referred to as a sulphur payment) which he conveyed to Munro in 1947, are not in dispute. Petitioner, in joint returns filed with his wife, returned the profits from those receipts in each taxable year as capital gain on

the installment basis. The Commissioner does not question use of the installment basis in returning the income for taxation nor does he question the accuracy of the amounts of the profits reported. He does question petitioner's right to use the capital gain method and has determined that the gain from conveyance of the sulphur payment is taxable as ordinary income and not as capital gain. That determination is based on the Commissioner's conclusion that the transaction in issue was an assignment of income itself rather than the conveyance of income producing property.

In support of the treatment of gains from the transaction as capital gains petitioner cites and relies upon our recent decisions in *Lester A. Nordan*, 22 T.C. 1132; *John David Hawn*, 23 T.C. 516, now on review in the Fifth Circuit; and other cases which were cited and discussed in the *Nordan* and *Hawn* cases. We think petitioner must prevail on the strength of these authorities, as well as the more recently [fol. 475] decided *Caldwell* v. *Campbell*, (C.A. 5) 218 F. 2d 567; *Wm. Fleming*, 24 T.C. ——, July 29, 1955; and *A. J. Stagter, Jr.*, 24 T.C. ——, August 25, 1955. It is true that in the aforementioned cases the mineral interests which were involved were oil payments, whereas here sulphur payments are involved. However, we think that fact makes no difference and that the same rule must be applicable to the sale and transfer of sulphur payments as applies to the sale and transfer of oil payments.[2] We so hold and, following the above decisions, we decide this issue in favor of petitioner. Since those cases adequately discussed the point of law involved it is unnecessary to here repeat the discussion.

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[2] Cases dealing with minerals other than oil and gas have played their parts in the development of the law applicable to oil and gas. See, e.g., GCM 22730, 1941-1 C.B. 214, citing *Bankers' Pocahontas Coal Co.* v. *Burnet*, 287 U. S. 308 (coal). Conversely, we think that those principles stated in oil and gas cases are applicable alike to other minerals, absent evidence of special circumstances compelling a distinction (such as substantial differences in controlling provisions of the Internal Revenue Code). As stated in GCM 22730, *supra*, at p. 219, "Like issues arise in the oil and mineral cases which are cited interchangeably in the evolution of the applicable rules."

In his brief, respondent attempts to distinguish the *Nordan*, *Hanch*, and *Caldwell* cases, all *supra*, upon the grounds that the taxpayers therein transferred their *entire* interests in oil in place, retaining only a reversionary interest therein after satisfaction of the oil payments from the interests conveyed, whereas here petitioner conveyed merely a fractional part of his interest in sulphur in place (86.2545514 per cent of his pooled royalty interest of $.00966133, that is to say $.00833333 per long ton on 6,000,000 long tons of sulphur to be produced) and retained not only a reversionary interest in the fraction conveyed (after satisfaction of the sulphur payment therefrom) but [fol. 476] a *continuing* interest in sulphur in place to the extent of $.001328 per long ton produced. Respondent argues, therefore, that the principle applied in those cases is not here applicable.

We fail to see any merit in this argument. Having once determined in the aforementioned cases that the conveyance of a mineral payment constitutes the transfer of property rather than the assignment of income, we see no distinction in carving out that interest in the manner herein employed by petitioner so long as the transaction itself is bona fide. The only particular in which respondent's argument differs from those made by him in the aforementioned cases is as regards the fractioning and, certainly, it is clear that the conveyance of a fractional part of one's interest in income-producing mineral property is not itself regarded by respondent as resulting in tax treatment different from that which would be applicable if the entire interest were conveyed.[3] Moreover, a careful study of the whole record in *Nordan*, as well as in *Wm. Fleming* and

[3] In GCM 12118, XII-2 C. B. 119, respondent stated that a taxpayer's unlimited conveyance, with no retained reversion, of a fraction of his royalty interest (e.g., conveyance in fee of one-half of a one-eighth overriding royalty) may be treated as the sale of a capital asset. Similarly, in I.T. 4003, 1950-1 C. B. 10, 11, respondent's apparent position is that the assignment of an oil payment representing a fraction of the taxpayer's interest, but extending over the entire life of the mineral property, may be treated as the sale of a capital asset.

A. J. Slagter, Jr., all *supra*, reveals that in fact the taxpayers therein did *not* convey their entire interests but, as did petitioner here, carved out the transferred mineral payments from the entire interests which they owned.

(Seal)

[fol. 477] Respondent in his determination of the deficiencies has allowed petitioner percentage depletion on the money received from Munro for sale of the sulphur payment. But petitioner was not the owner of the sulphur royalties at the times he received such money from Munro and, therefore, was clearly not entitled (nor does he claim to be so entitled) to any deductions for depletion. See *John David Hawn, supra*.

Having decided the primary issue in petitioner's favor it is not necessary to decide his alternative contention that, if we should hold that his gains from the sale and transfer to Munro are taxable as ordinary income, then it should all have been reported in 1947, the year of sale, and that none should have been reported in 1948 and 1949.

Decision will be entered under Rule 50.

[fol. 478] In The Tax Court of The United States

[Title omitted]

Decision—Entered December 14, 1955

Pursuant to the Findings of Fact and Opinion of the Court filed September 22, 1955, the parties on December 13, 1955, having filed an agreed computation of the tax, now therefore, it is

Ordered and Decided: that there is a deficiency in income tax for the calendar year 1948 in the amount of $247.77, and that there is no deficiency in income tax for the calendar year 1949.

(Signed) Eugene Black, Judge.

[fol. 479]

Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 480] Minute Entry of Argument and Submission
December 3, 1956

(Omitted in Printing)

[fol. 481] In The United States Court of Appeals for The Fifth Circuit

No. 16105

Commissioner of Internal Revenue, Petitioner,

versus.

W. F. Weed, Individual, and Estate of Eleanor M. Weed, Deceased, W. F. Weed, Executor, Respondents.

Petition for Review of Decision of The Tax Court of the United States (District of Texas)

Opinion—February 1, 1957

Before Hutcheson, Chief Judge, and Holmes and Borah, Circuit Judges.

Hutcheson, *Chief Judge*: This appeal is from a decision of the Tax Court, 24 T.C. 1025, holding that gain resulting from taxpayer's sale and transfer of a sulphur payment carved out his pooled royalty was taxable as long term capital gain.

[fol. 482] It presents the single question whether the proceeds received by taxpayer from the transfer of a sulphur payment carved out of his $.009956133 per long ton pooled royalty interest, which he had owned for years, consisting of approximately 86 percent thereof, effective until the assignee shall have received 6,000,000 long tons of sulphur and no longer, which was expected to pay out within four years but actually paid out in 28 months, constituted ordinary income subject to depletion rather than, as the Tax Court held, capital gain under 1939 Code, Sec. 117.

Here, contending that this case is clearly controlled by, and requires the same result as that reached in, *Commis-*

sioner v. *Hawn*, 231 F(2) 340, and urging that the transfer of a sulphur payment carved out of royalty has no better status than the transfer of an oil payment so carved, the commissioner insists that the transfer was not effective as a sale of capital assets because it was not of a substantial part of the total property owned by taxpayer assignor.

The taxpayer, pointing out that the Texas courts have determined that mineral payment rights in Texas are real property interest[1] and that that view has been consistently held by the Texas Courts, appropriate United States Courts of Appeals,[2] and the United States Supreme [fol. 483] Court, which, in *Thomas* v. *Perkins*, 301 U.S. 655, determined the nature of an oil payment for income tax purposes and established the rule that an oil payment creates an economic interest in the mineral in place, insists that under the undisputed facts of this case,[3] fully

[1] Sheffield v. Hogg, 24 Tex. 290; Tennant v. Dunn, 130 Texas, 285; A. W. Walker, Jr., "Oil Payments", 20 Texas Law Review, p. 259.

[2] Lee v. Commissioner, 126 F(2) 825; Fleming v. Campbell, 205 F(2) 549; Oritz Oil Co. v. Commissioner, 102 F(2) 508; to which may be added Caldwell v. Campbell, 218 F(2) 567 and Commissioner v. Hawn, 231 F(2) 340.

[3] Briefly summarized, these are:

Dec. 23, 1947, taxpayer Weed owned a pooled overriding royalty interest in sulphur produced by the Texas Gulf Sulphur Company from a sulphur deposit in Wharton County, Texas, known as Boling-Dogue; this interest entitled him to receive $.00966133 per long ton of sulphur produced.

At the same time taxpayer was supplying funds and credit for a number of companies of which he was principal stockholder, and anticipated he would need all of the bank credit available to him for these enterprises. Further, he realized that, in addition, he needed a definite source of funds for payment of his individual federal income taxes.

In the fall of 1947, taxpayer negotiated with Munro for the realization of these funds, and transferred to Munro 86.254514% of taxpayer's pooled royalty interest of $.00966133 (i.e. $.00833333) per long ton on six million tons of Boling Dogue sulphur in exchange for $13,900.00 cash and

[fol. 484] set out in the opinion of the Tax Court, to which reference is here made, the transaction constituted the bona fide and effective sale of a substantial mineral interest entitling it to capital gains treatment.

Upon the considerations advanced by the Tax Court and for the reasons set out by us in *Schofield v. O'Connor*, this day decided, we agree with the respondents and with the Tax Court that the gain in question constituted not ordinary income subject to depletion but capital gain.

The Tax Court's decision is therefore Affirmed.

---

two notes of $16,300.00 each; the six million tons of sulphur were produced 28 months thereafter.

The taxpayer disclosed the transaction fully in his 1947 tax return, treating the proceeds as capital gains and reporting the profits on the installment basis. Taxpayer's 1948 and 1949 returns reported the $16,300 received from Munro for each such year as long term capital gain. The Commissioner determined that the 1948 and 1949 payments were taxable as ordinary income, subject to depletion. The Tax Court held these proceeds were realized from the sale of a sulphur payment and constituted capital gain.

The following are the pertinent portions of the assignment:

"I, W. F. Wood, in consideration of [$13,900 cash and the two $16,300 notes] * * * do hereby Sell, Transfer, and Assign, unto the said Marion F. Munro, * * * $6.254514 [of $.0039063133 per long ton pooled royalty on sulphur produced by Texas Gulf Sulphur Company at Boling Dome, Wharton County, Texas, from lands and premises described in said above named conveyances [to petitioners from his father and his father's estate] until 6,000,000 long tons of sulphur have been produced and accounted for to the said Marion F. Munro therefrom, which royalty so sold and here assigned and conveyed amounts to $.00833333 per long ton.

* * * * * * *

"This assignment and the royalty transferred and assigned hereby on sulphur produced form Boling Dome * * * shall continue to be effective until said Marion F. Munro shall have received said royalty on 6,000,000 long tons of sulphur and no longer.

[fol. 485] In the United States Court of Appeals for the Fifth Circuit

No. 16105.

Commissioner of Internal Revenue,

versus

W. F. Weed, Individual, and Estate of Eleanor M. Weed, Deceased, W. F. Weed, Executor.

Judgment. February 1, 1957

This cause came on to be heard on the petition of Commissioner of Internal Revenue for a review of a decision of the said Tax Court of the United States, and was argued by counsel:

On consideration whereof, It is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby, affirmed.

[fol. 486] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 487] Supreme Court of the United States, October Term, 1956

No. 921

Commissioner of Internal Revenue et al., Petitioners,

vs.

P. G. Lake, Inc., et al.

Order allowing certiorari. June 3, 1957

The petition herein for a writ of certiorari to the United States Court of Appeals for the Fifth Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

No. 921

FILED
APR 17 1957
JOHN T. FEY, Clerk

In the Supreme Court of the United States

OCTOBER TERM, 1956

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

P. G. LAKE, INC.

FRANK SCHOFIELD, JUDSON COLLECTOR OF INTERNAL REVENUE, PETITIONER,

v.

DENNIS M. O'CONNOR AND KATHERINE O'CONNOR, INDEPENDENT EXECUTORS OF THE ESTATE OF THOMAS O'CONNOR, DECEASED, AND DENNIS M. O'CONNOR, KATHERINE O'CONNOR, MARY O'CONNOR BRAGAN, JOINED BY HER HUSBAND, D. H. BRAGAN, AND THOMAS O'CONNOR, JR.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

WM. FLEMING AND BESSIE M. FLEMING, HUSBAND AND WIFE, J. HOWARD WALSH AND MARY D. WALSH, HUSBAND AND WIFE, AND MARY D. FLEMING WALSH.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

JOHN WEATHERLY AND NELL WEATHERLY, HUSBAND AND WIFE.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

W. T. WELD, INDIVIDUALLY, AND ESTATE OF ELEANOR M. WELD, DECEASED, W. T. WELD, EXECUTOR.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1956

Nos.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

P. G. LAKE, INC.

FRANK SCOFIELD, FORMER COLLECTOR OF INTERNAL REVENUE, PETITIONER

v.

DENNIS M. O'CONNOR AND KATHERINE O'CONNOR, INDEPENDENT EXECUTORS OF THE ESTATE OF THOMAS O'CONNOR, DECEASED, AND DENNIS M. O'CONNOR, KATHERINE O'CONNOR, MARY O'CONNOR BRAMAN, JOINED BY HER HUSBAND, D. H. BRAMAN, AND THOMAS O'CONNOR, JR.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WM. FLEMING AND BESSIE M. FLEMING, HUSBAND AND WIFE, F. HOWARD WALSH AND MARY D. WALSH, HUSBAND AND WIFE, AND MARY D. FLEMING WALSH

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN WEATHER AND NELL WEATHER, HUSBAND AND WIFE

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

W. F. WEED, INDIVIDUAL, AND ESTATE OF ELEANOR M. WEED, DECEASED, W. F. WEED, EXECUTOR

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue and Frank Scofield, former Collector of Internal Revenue, prays that writs of certiorari issue to review the judgments of the Court of Appeals for the Fifth Circuit in the above-entitled cases, which, although entirely separate proceedings,

involve the same ultimate question and were decided by the court below on the same day after having been argued *seriatim* before the same panel of judges. (See Rule 23 (5) of the Revised Rules of this Court.)

OPINIONS BELOW

The opinion of the Tax Court in the *Lee* case (Appendix B, *infra*, pp. 28-30) is reported at 24 T. C. 1016. The opinion of the Court of Appeals (Appendix B, *infra*, pp. 69-83) is not as yet reported.

The findings of fact and conclusions of law of the District Court in the *O'Connor* case (Appendix B, *infra*, pp. 30-35) are reported at 143 F. Supp. 240. The opinion of the Court of Appeals (Appendix B, *infra*, pp. 83-90) is not as yet reported.

The findings of fact and opinion of the Tax Court in the *Fleming* case (Appendix B, *infra*, pp. 36-53) are reported at 24 T. C. 818. The opinion of the Court of Appeals (Appendix B, *infra*, pp. 91-101) is not as yet reported.

The memorandum findings of fact and opinion of the Tax Court in the *Wyatt* case (Appendix B, *infra*, pp. 53-56) are not officially reported. The opinion of the Court of Appeals (Appendix B, *infra*, pp. 102-103) is not as yet reported.

The findings of fact and opinion of the Tax Court in the *Wood* case (Appendix B, *infra*, pp. 57-68) are reported at 24 T. C. 1025. The opinion of the Court of Appeals (Appendix B, *infra*, pp. 104-107) is not as yet reported.

JURISDICTION

The judgments of the Court of Appeals in all five cases were entered on February 1, 1957. (Appendix B, *infra*, pp. 107 *et seq.*) The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTIONS PRESENTED

All five cases present the following general question:

Whether the consideration received for the so-called sale or exchange of an oil (or sulphur) payment right is taxable as ordinary income subject to depletion, as the Government contends, or as capital gain under Section 117 of the Internal Revenue Code of 1939, as the court below held.

The *Fleming* case presents the following additional related question:

Whether the court below erred in holding that the so-called exchanges of oil payment rights for fee simple interests in real estate constitute tax-free exchanges of property of like kind within the meaning of Section 112(b)(1) of the 1939 Code.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 and Treasury Regulations are set forth in Appendix A, *infra*, pp. 22-27. They are as follows: Sections 22(a), 112(a) and (b)(1), 117(a)(1) and (4), (b), and (j)(1)(2), of the 1939 Code, and Sections 29.112(a)-1 and 29.112(b)(1)-1 of Treasury Regulations 111.

STATEMENT

The *Lake*, *Fleming*, *Wrather*, and *Wood* cases involve deficiencies in income tax and originated in the Tax Court by the filing of petitions for review pursuant to Section 272(a)(1) of the Internal Revenue Code of 1939. The *O'Connor* case is a suit for refund of income taxes filed in a district court pursuant to 28 U.S.C., Section 1340. In all five cases, the controversy is with respect to the proper treatment, for income tax pur-

poses, of one or more so-called sales or exchanges of oil (or sulphur) payment rights.[1]

The lower courts held that the transactions constituted sales, and in the *Fleming* case exchanges, of a capital asset within the meaning of Section 117 of the Internal Revenue Code of 1939 rather than, as the Government contended, assignments of future income. (Appendix B, *infra*, pp. 28-68.)[2] In all five cases, the Fifth Circuit affirmed the lower court. (Appendix B, *infra*, pp. 69-107.)

The following is a summary of the basic facts in each case:

Lake case

P. G. Lake, Inc. (hereinafter called the corporation or the taxpayer-corporation) is a Delaware corporation with its principal office in Tyler, Texas. It is engaged in the business of producing oil and gas and

[1] "An 'oil payment' or 'oil payment right' is the right to a specified sum of money payable out of a specified percentage of the oil or the proceeds received from the sale of such oil if, as and when produced." *Anderson v. Helvering*, 310 U.S. 404, 410. The right is free and clear of the costs and expenses of production and in that respect is similar to a royalty interest which, however, is "a right to receive a specified percentage of all oil and gas produced during the term of the lease." *Anderson v. Helvering*, *supra*, p. 409.

[2] In each of the four cases which originated in the Tax Court, *Lake*, *Fleming*, *Wrather*, and *Weed*, the Tax Court's decision was based upon the Fifth Circuit's decision in *Caldwell v. Campbell*, 218 F. 2d 567, and the Tax Court's own decision in *Hazen v. Commissioner*, 23 T.C. 546, which was subsequently reversed by the Fifth Circuit *(Commissioner v. Hazen*, 231 F. 2d 340). In the *Weed* case, the Tax Court also relied upon its own decision in *Slagter v. Commissioner*, 24 T.C. 935, which was subsequently reversed by the Seventh Circuit *(Commissioner v. Slagter*, 238 F. 2d 901). In all four cases, the Tax Court also relied upon its own decision in *Nichols v. Commissioner*, 22 T.C. 1132, which, however, involved the gift tax rather than the income tax. In the fifth case *(O'Connor)*, the District Court wrote no opinion.

on December 29, 1950, owned the 7½ working interest in two commercial oil and gas leases covering land in Texas, the Reid and Owens Leases, from which it, as the operator, was then producing oil in substantial quantities. (Appendix B, *infra*, p. 29; Stip., *Lake* R. 31.)

Being indebted to its president, P. G. Lake, in the sum of $600,000, the taxpayer-corporation on December 29, 1950, assigned to its president, in consideration of the cancellation of the $600,000 indebtedness, an oil payment right in the amount of $900,000 plus an amount equal to interest at 3 per cent per annum on the unpaid balance remaining from month to month, payable out of 25 per cent of the oil attributable to the corporation's working interest in the Reid and Owens Leases. On the date of the assignment, it could have been estimated with reasonable accuracy that the assigned oil payment right would require three or more years to pay out. The actual pay-out period was from January 1951, to February 1954, a little over 3 years. (Appendix B, *infra*, p. 29; Stip., *Lake* R. 31-33.)

O'Connor case

In this case, the so-called sale of an oil payment right was made by the executors, heirs, and devisees of the estate of Thomas O'Connor for the purpose of raising money to pay federal estate taxes, state inheritance taxes, and administration expenses. In the fiduciary income tax returns filed by the executors for the fiscal period ended November 30, 1948, the proceeds from the so-called sale were reported as ordinary income subject

[1] The "working interest" is the name commonly given to the leasehold interest and is the entire mineral interest less the royalty interest customarily retained by the lessor. See Brooding and Burton, *Taxation of Oil and Gas Income*, Sec. 2.04 (1954); Welsch, *Tax Aspects of Owning and Disposing of Interests in Oil and Gas*, 31 Taxes, Tax Magazine 855 (1953).

APPENDIX A

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

(1) *Property held for productive use or investment.*—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or

to depletion, but claims for refund were subsequently filed on the ground that the proceeds should have been reported as capital gain. The claims for refund were denied, and this suit for refund followed. (Appendix B, *infra*, pp. 31, 33, 34.)

The so-called sale of the oil payment right was made by the estate on November 26, 1948, as the owner of eight oil royalty interests which the decedent, who died in 1946, had reserved in 1934 in executing oil and gas leases on property owned by him. (*O'Connor* R. 16-21, 48-49.) The sale was to D. C. Blackburn, the president of a bank of whose stock 12 per cent was owned by the O'Connors (*O'Connor* R. 59, 60), and was of an oil payment right in the amount of $10,000,000 plus an amount equal to 4 per cent interest per annum on the unrealized balance thereof remaining from month to month, payable out of the oil attributable to the estate's eight royalty interests. For the oil payment assignment, Blackburn paid the estate $9,990,350 which he borrowed from the Chase National Bank in New York on his personal 36-month note, bearing 3½ per cent interest, without any security other than a deed of trust on the oil payment right he received from the estate. (Appendix B, *infra*, p. 31; *O'Connor* R. 58, 60, 69-70.) Before making the loan, the Chase National Bank in New York sent its own engineers down to Texas to value the properties and received their approval of the collateral (the oil payment right). (*O'Connor* R. 61-62.)

On the date of the oil payment assignment, it could be estimated from available information that pay-out of the assigned oil payment right would take about 4,000,000 barrels of the 23,150,000 barrels of oil in place, attributable to the royalty interests (or about 17 per

cent). The assigned oil payment right paid out in 3 years. (*O'Connor* R. 32, 71.)

Fleming case

This case involves oil payment assignments made in exchange for real estate. In their income tax returns, the taxpayers treated the transactions as tax-free exchanges of property of like kind within the meaning of Section 112(b)(1) of the 1939 Code, reporting no income at all from the transactions. The Commissioner determined deficiencies on the ground that the transactions were not tax-free and that the income therefrom was taxable as ordinary income subject to depletion. The Tax Court held that the transactions were not exchanges of property of like kind so as to be tax free under Section 112(b)(1), but held that the income from the transactions was taxable as capital gain rather than as ordinary income subject to depletion. (Appendix B, *infra*, pp. 45-50, 53.) On cross-appeals to the Fifth Circuit, that court held that the transactions are not taxable at all under Section 112(b)(1) but that, if such a view is erroneous, the income from the transactions is taxable as capital gain under Section 117 of the 1939 Code. (Appendix B, *infra*, pp. 91-98.)

Two so-called exchanges are involved. The first one (see Appendix B, *infra*, pp. 37-45) was made on May 19, 1948, and consisted of separate oil payment assignments by three related parties—William Fleming individually, a partnership in which he and a trust were the partners, and the trust—for undivided fee simple interests in a ranch. Four oil payment assignments were made, one by William Fleming individually, one by the partnership, and two by the trust. Three were made by the assignors as owners of leasehold interests

extent such gain is taken into account in computing net income;

* * * * *

(b) [as amended by Sec 150(c) of the Revenue Act of 1942, *supra*] *Percentage Taken Into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;
50 per centum if the capital asset has been held for more than 6 months.

* * * * *

(j) [as added by Sec 151(b) of the Revenue Act of 1942, *supra*] *Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in

and the other as the owner of a royalty interest. All of those interests were held by the assignors for productive use in their respective businesses of producing oil. The oil payment assignments varied as to amount, estimated pay-out period, and the percentage of the assignor's interest out of which they were payable. However, as to each assignor, the oil payment assignment or assignments was in an amount which represented the fair market value of the undivided interest in the ranch received by such assignor, plus an amount equal to a specified percentage of interest per annum on the balance thereof remaining unpaid from time to time.[4]

The other so called exchange (see Appendix B, *infra*, pp. 50-53) consists of an oil payment assignment by taxpayer F. Howard Walsh, as the owner of oil and gas leasehold interests held by him for productive use in his business of producing oil, for the fee simple title to business real estate in Fort Worth, Texas. The oil payment assignment was in the amount of $865,000 (the fair market value of the real estate received (see *Fleming* R. 117, 119)), plus 7 per cent interest per annum on the unpaid balance thereof remaining unpaid from time to time, and was payable only out of fractional parts of the assignor's interests in several leases. The estimated pay-out period for the assigned oil payment right was about 3 years.

Wrather case

Like the *Lake* and *Fleming* cases, this case involves oil payment assignments by a leasehold owner. Taxpayer John Wrather was a member of a partnership

[4] This is shown by a comparison of the face amount of the oil payment assignments (Appendix B, *infra*, pp. 38-43) with the Commissioner's uncontested determinations of fair market value (*id.* p. 44).

which owned a number of oil and gas leasehold interests, including an undivided 7/24 leasehold, or "working", interest in the Brown Lease on land located in Illinois and an undivided 5/16 leasehold interest in the Kieffer "A" Lease on land located in Indiana. Both of the latter interests were held by the partnership for the development and production of oil and gas. (Appendix B, *infra*, pp. 54-55.)

In 1948 the partners made three so-called sales to the Indiana Farm Bureau Cooperative Association, Inc. (hereinafter called the Cooperative) of oil payment rights payable out of the production under the Brown and Kieffer "A" Leases. Even in form, however, each transaction involved only an "Oil Payment Agreement" (Ex. J-10, not printed) which stated simply that the Cooperative "shall be paid" a specified sum "out of the oil produced and saved", to the extent of a specified portion, until the full specified sum shall have been paid to Cooperative. The following are the other pertinent facts relating to each oil payment assignment (Appendix B *infra*, pp. 54-55):

Brown Lease	
Date	June 19, 1948
Amount	$130,000
Consideration	$125,000
Payable out of 9/10 of oil attributable to assignor's leasehold interest	
Estimated pay-out period	4 to 6 years
Actual pay-out period	4 years
Kieffer "A" Lease	
(1) Date	June 19, 1948
Amount	$155,000
Payable out of 9/10 of oil attributable to assignor's leasehold interest	
(2) Date	August 16, 1948
Amount	$12,500
Payable out of 9/10 of oil attributable to assignor's leasehold interest	
Total consideration for the two assignments	$162,500
Estimated pay-out period for both assignments	4 to 6 years
Actual pay-out period for both assignments	3 years and 5 months (from first assignment)

Weed case

Here the so-called sale was of a sulphur, instead of an oil, payment right. The taxpayer was the owner of a pooled or entirety royalty interest in sulphur produced by the Texas Gulf Sulphur Company from a tract of land referred to as Boling Dome, in Wharton County, Texas. The royalty interest entitled taxpayer to receive $0.0390625 per long ton of sulphur produced from Boling Dome by the aforementioned company, irrespective of what the market price for such sulphur might be. (Appendix B, *infra*, pp. 59-60.)

On December 21, 1947, taxpayer assigned to Marion Munro a sulphur payment consisting of $0.254511 per cent of the pooled royalty interest (*i.e.*, $0.0099609375 per long ton on 6,000,000 long tons of the remaining 24,000,000 long tons of sulphur to be produced from Boling Dome). For the sulphur payment assignment, Munro gave taxpayer

Check dated 12-21-47	$15,000
Promissory note due 12-21-48 with interest after maturity	10,500
Promissory note due 12-21-49 with interest after maturity	10,500
	$36,000

Munro obtained the purchase money by loans from a bank, as security for which he used the sulphur payment. The assigned sulphur payment paid out in 28 months. Receipt of royalty checks by Munro under the sulphur payment made it unnecessary for him to borrow more than $11,500 in order to pay the $15,000 note due taxpayer. (Appendix B, *infra*, pp. 61-64.)

The sulphur payment assignment was preceded by discussions between taxpayer and Munro, the assignee,

a C.P.A. who was then retained by two of taxpayer's corporations and who subsequently prepared taxpayer's individual joint income tax returns for 1948 and 1949. Taking into account various considerations, including tax savings to taxpayer and the amount of annual royalty payments which Munro would probably receive, it was agreed that the sulphur payment assignment would be based upon taxpayer's anticipated requirements for funds to pay taxes for the succeeding three years and upon a four year pay out period to Munro from sulphur production. Munro advised taxpayer that the latter's tax saving from the transaction would be about $1,000 to $1,500 and Munro estimated that his own profit from the transaction (after allowance for the discount factor) would approach $2,000. (Appendix B, *infra*, pp. 60-61.)

REASONS FOR GRANTING THE WRIT

Each taxpayer here, as the owner of an interest in mineral properties, would normally realize income as the minerals are produced and sold, and the balance of that income (after deduction of the statutory allowance for depletion) would be taxed to them at ordinary income rates. However (by a method peculiarly available in the natural resources industry), these taxpayers made a temporary transfer of a portion of their rights, for a lump sum consideration; as a result, for a relatively short period of time, the transferees of these rights become entitled to collect the income which the taxpayers would otherwise have collected. The taxpayers contend, merely because of this temporary transfer, that they are entitled to preferential capital gain treatment on this lump sum consideration even

though it is, in effect, only a substitute for the income which they would otherwise have collected in the future. The Court of Appeals, in upholding the taxpayers' contention, has reached a conclusion which is in conflict with the decisions of this Court and other Courts of Appeals, and which raises important and substantial questions in the administration of the revenue laws.

1. The decisions below are in direct conflict with the recent decision of the Seventh Circuit in *Commissioner v. Slagter*, 238 F. 2d 901, where, under analogous circumstances, it was held that the taxpayers realized ordinary income rather than capital gain. The decisions below are also in conflict, in principle, with the following decisions of this Court: *Burnet v. Harmel*, 287 U.S. 103; *Corn Products Co. v. Commissioner*, 350 U.S. 46; *Watson v. Commissioner*, 345 U.S. 544; *Hort v. Commissioner*, 313 U.S. 28; *Harrison v. Schaffner*, 312 U.S. 579; *Helvering v. Horst*, 311 U.S. 112; *Helvering v. Clifford*, 309 U.S. 331; *Commissioner v. Sunnen*, 333 U.S. 591. And the decisions in the present cases are also out of harmony with many decisions of the Courts of Appeals which have followed the principles declared by this Court in the above-cited cases.

In *Commissioner v. Slagter*, *supra*, the owners of the working interest in oil and gas leases transferred, for a lump sum consideration of $501,000, a portion of their interest which entitled the transferee to receive the sum of $513,500 from 60% of the transferors' share of the oil and gas which might be produced. The transferors undertook no personal obligation to make any part of the payments; the transferee could look only to future production of oil and gas from the leases; and the transferee's interest was to terminate when the speci-

fied sum had been recovered out of future production.[6] The transferee received the sum of $513,500, and its interest actually terminated within a period of 5 years and 3 months after the transfer.

The Tax Court in *Slaytor* (24 T.C. 935), following the lead of the Fifth Circuit,[7] had held that the lump sum consideration received by the transferors represented proceeds from the sale of a capital asset and that the gain was thus taxable to them as long-term capital gain. The Seventh Circuit reversed, holding that the gain was taxable to the transferors as ordinary income, to be taxed during the period when the oil proceeds were actually received by the transferee.[8] That court, rejecting the contention that local concepts of property law were germane in construing the federal taxing statute, held that the transfer of the oil payment right did not represent a "sale" of "capital assets" as Con-

[6] This arrangement is known in the industry as an "in-oil payment". See note 1, *supra*. Although different language is used in various instruments of transfer, the ultimate effect of these provisions is to entitle the holder of an oil payment right to receive a specified sum of money payable out of a stipulated portion of production of the wells in which the transferor has an interest, free and clear of any expenses of production. Once the holder of the oil payment right has received the specified sum, his interest ceases and the transferor has all the rights which he originally possessed prior to the transfer. Similar arrangements can be made with respect to other mineral interests, as in the *Weed* case, which involves a sulphur payment right.

[7] *Caldwell v. Campbell*, 218 F. 2d 567 (C.A. 5th).

[8] While we believe that the Seventh Circuit reached the correct conclusion on the *nature* of the income, it reached a doubtful result on the question of *when* the income was realized. See *Hort v. Commissioner*, 313 U.S. 28; *North American Oil v. Burnet*, 286 U.S. 417; *Healy v. Commissioner*, 345 U.S. 278. This point was not briefed or argued by the parties, both of whom assumed that the income, whatever its nature, was taxable in the year when the transferors received the lump sum consideration.

gress used those terms in Section 117 of the 1939 Code (Appendix A, *infra*, pp. 23-25). Instead, the Seventh Circuit, relying on a long line of decisions of this Court dealing with anticipatory assignments of income, concluded that the transfer was tantamount to an assignment, for a consideration, of future income, and held that the income realized by the transferors was taxable as ordinary income.

The decisions below stand in that contradiction to *Slaytor*. Unlike the Seventh Circuit, and in opposition to the decisions of this Court (*Burnet* v. *Harmel*, 287 U.S. 103, 110-111; *Watson* v. *Commissioner*, 345 U.S. 544, 551), the Fifth Circuit concluded that local property concepts were persuasive in ascertaining whether there has been a sale of "property" which would qualify for capital gain treatment under the federal taxing statute.[*] And, unlike the Seventh Circuit, and in opposition to this Court's holding regarding the fundamental legislative purpose of the capital gains provisions (see pp. 17-19, *infra*, and *Corn Products Co.* v. *Commis-*

[*] The Court of Appeals, in its emphasis on Texas law, placed heavy reliance on the decision in *Tennant, Rex* v. *Dunn*, 130 Tex. 285. Although we disagree with the conclusion of the court below that Texas law aids in answering the question of what "property" interests are capital assets under Code Section 117, it may be noted that in the *Dunn* case it was stated that the oil payment right there involved did not represent (p. 290) "a fractional interest in the entire leasehold estate". Within the framework of the issue presented in *Dunn*, the Texas Supreme Court held that the oil payment right represented an "interest in land" and the court below holds that this is "property" which is a capital asset under Section 117 of the federal taxing statute. In contrast stands this Court's statement in *Hort* v. *Commissioner*, *supra*, p. 31: "We assume that the lease was 'property,' whatever that signifies abstractly. * * * Simply because the lease was 'property' the amount received for its cancellation was not a return of capital, quite apart from the fact that 'property' and 'capital' are not necessarily synonymous in the Revenue Act of 1932 or in common usage."

sioner, 350 U.S. 46, 51-52), the court below refused to view the transfer as encompassing no more than a temporary disposition of the tranferors' rights to collect ordinary income; instead, it held that the right transferred amounted to a sale of property which was a sale of a capital asset under Code Section 117. In so holding, the court below departed from the basic principles, frequently applied by this Court, that amounts received as a substitute for rights to future income are not to be considered as capital gains (*Hort* v. *Commissioner*, 313 U.S. 28, 30-31) and that temporary assignments of rights to income are not to be considered as transfers of the income-producing property itself (*Harrison* v. *Schaffner*, 312 U.S. 579; *Helvering* v. *Horst*, 311 U.S. 112; *Helvering* v. *Clifford*, 309 U.S. 331; *Commissioner* v. *Sunnen*, 333 U.S. 591).

While there are factual differences among the cases decided by the court below, in their essential respects they are alike and are indistinguishable from *Slaytor*. In each case, the owner of an income-producing interest in mineral property transferred to another the right to collect, from a part of that interest, a limited amount of the income from the property. In each case, the transferor retained all other present rights in the property and regained all his rights as soon as the transferee had collected the full amount of the assigned income. For example, in the *O'Connor* case, the owner of royalty interests, for a cash consideration of $9,990,350, invested the transferee with the right to collect $10,000,000 (plus 4% per year on the monthly, unrealized balance) out of future production to which the royalty owner would otherwise have been entitled. The transferee, who collected the agreed amount during the ensuing three years and whose rights then terminated, was able to borrow

the "purchase price" from a bank on his personal note, secured only by the oil payment right, the bank, by its own geological survey, having first ascertained what was the estimated future production from the wells.[9] In the *Lake* case, the taxpayer corporation was the operator of oil and gas wells, having a $\frac{7}{8}$ working interest. To satisfy an indebtedness of $600,000 owing to its president, the corporation transferred to him the right to collect, out of the oil attributable to 25% of its $\frac{7}{8}$ interest in the leases, the amount of $600,000 (plus interest at 3% per year on the monthly unpaid balances). This amount was actually paid out during a period of approximately 3 years.

The significant facts of each of the cases decided by the court below can not be successfully distinguished from those involved in *Sluder*.[10] The decisions of these two Courts of Appeals, one permitting capital gains taxation and the other requiring taxation at ordinary income rates, are irreconcilable.[11]

[9] It was stipulated that there were approximately 23,150,000 barrels of recoverable oil under the properties and that approximately 19,150,000 barrels would remain after the $10,000,000 oil payment had been recovered.

[10] The court below (*Lake* opinion, Appendix B, *infra*, pp. 82-83) without giving any amplifying reasons, stated that there was nothing in *Sluder* which supported the Government's position "as applied to the facts of this case" and that "it is not necessary for us to determine whether the [*Sluder*] case was or was not correctly decided on its facts," although the court below was inclined to the view that the Seventh Circuit "did not give full effect to the true nature of a limited overriding royalty or oil payment interest." As indicated above, we can discern no material differences between the cases.

[11] The *Fleming* case below (Appendix B, *infra*, pp. 91-98) also involves another question which is intimately connected with the principal issue. In *Fleming*, the taxpayers received a fee simple interest in real estate in exchange for an oil payment right. Reversing the Tax Court, the Court of Appeals (Judge Borah dissent-

2. For the reasons already stated, the decisions below are erroneous. This Court has held that the capital gains provisions are to be "narrowly applied" so as to effectuate the congressional policy of taxing at ordinary income rates the profits "arising from the everyday operation of a business" while, at the same time, limiting preferential capital gain treatment "to transactions in property which are not the normal source of business income." *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 52. And, as the *Corn Products* case demonstrates, a transaction may fit the literal language of the statute and yet not qualify for capital gain treatment where it does not fall within the obvious purpose of Congress and where a taxpayer would otherwise be able (pp. 53-54) "to transmute ordinary income into capital gain at will." Such is the situation here.

In *Burnet* v. *Harmel*, 287 U.S. 103, 106, it was recognized that the production of oil and gas necessarily involved sales of property and that, on the granting of a lease, local law viewed the lessor as transferring title to the underlying minerals. Nonetheless, it was ruled that the production and sale of minerals from a mine or oil well so closely resembled a manufacturing business as to require the conclusion that it was not the purpose of the capital gains provisions to encompass such transactions. Despite the provisions of local law, the decision held that, on the granting of a lease, the lessor did not sell any property and was not entitled to capital gain taxation. And the significant aspect of *Harmel* in

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ings held that this was a non-taxable exchange of "property" of like kind under Code section 112(b)(4). (Appendix B, *infra*, pp. 94-98). The court went further and stated that, if it was wrong in this conclusion, the gain was taxable as capital gain (Appendix B, *infra*, p. 98).

relation to the issue here is its express holding that a lump sum bonus paid to the lessor by the lessee as consideration for the granting of the lease was taxable as ordinary income, the Court (pp. 111-112) refusing to draw any distinction between the lump sum consideration and the royalties which were to be paid to the lessor over a period of time.

Ever since *Harmel*, it has been clear that lessors and lessees realize ordinary income as the minerals are produced and sold. And the lump sum considerations paid in the present group of cases for the oil payment rights, standing as they do as a substitute for the lessor's or lessee's right to collect ordinary income during a short, future period, no more fit the capital gains provisions of the statute than did the lump sum bonus paid to the lessor in *Harmel*. In *Harmel*, the bonus was consideration for the right to produce and sell minerals for the full life of the lease, and thus was a substitute for the rights which the lessor possessed before granting the lease. See also *Hort* v. *Commissioner*, *supra*. The present group of cases are clearer illustrations of situations where favored capital gain treatment was not within the intendment of Congress, for here the lump sum consideration is a substitute for rights of the transferors which are far more transitory and do not extend through the life of the mineral properties.

The situation here does not even qualify under the literal language of Section 117 which requires that there be a "sale or exchange" of "property." This Court has uniformly held that a temporary, donative assignment of the income from property does not constitute a disposition of the income producing property sufficient for the transferee to be considered the taxable owner of the property or its income. See cases cited *supra*, p. 12. By

transferring no more than the right to collect a definite amount of income (which the transferors would have otherwise collected) out of future production and, in all other respects having retained their interest in the property, the transferors here did not sell any "property", as that term is used in Section 117.[12]

Thomas v. *Perkins*, 301 U.S. 655, and *Palmer* v. *Bender*, 287 U.S. 551, do not support the views of the court below. In *Palmer* v. *Bender*, it was held that an owner of a leasehold interest who transferred it for cash bonus, a future payment of $1,000,000 to be paid out of a fractional part of the oil produced, and a royalty interest, continued to possess a depletable interest in the property. And in *Thomas* v. *Perkins*, where the owner of the leases on *undeveloped* property transferred them for a consideration payable only out of a fractional portion of future production, it was similarly held that the transferor, to that extent, continued to have a depletable economic interest so that the income derived from that interest following the development of the property was attributable to the transferor rather than the transferee. Although those cases are distinguishable in other respects, we need only emphasize at this point that nei-

[12] The Courts of Appeals, in a variety of contexts, have held that a transfer of what is, in effect, a right to collect ordinary income is not a sale of "property" which qualifies for capital gain taxation. See *Helvering* v. *Smith*, 90 F. 2d 590 (C.A. 2d) (right of partner to fees not yet collected); *Rhodes' Estate* v. *Commissioner*, 131 F. 2d 50 (C.A. 6th) (right of stockholder to dividend declared but not yet payable); *Fisher* v. *Commissioner*, 209 F. 2d 513 (C.A. 6th), certiorari denied, 347 U.S. 1014 (sale of notes with right to collect defaulted interest); *United States* v. *Snow*, 223 F. 2d 103 (C.A. 9th), certiorari denied, 350 U.S. 831, and *Hulbert* v. *Commissioner*, 227 F. 2d 399 (C.A. 7th) (transfer of right to uncollected partnership income). The decisions below conflict, in principle, with these decisions too.

ther case involved the construction or application of the capital gains provision.

3. The decisions below present questions of considerable importance to the administration of the revenue which, we submit, warrant review and definitive adjudication by this Court.

The position of Internal Revenue Service regarding the taxable nature of income realized in transactions of this nature was stated in G.C.M. 24849, 1946-1 Cum. Bull. 66, and was further explained in I.T. 4003, 1950-1 Cum. Bull. 10. A survey conducted by Internal Revenue Service indicates that taxpayers generally accepted the position stated in G.C.M. 24849 and I.T. 4003 (*supra*). However, in the first case to reach an appellate court, the Fifth Circuit rejected the Government's position and held that capital gain was realized by a royalty owner who transferred oil payment rights which paid out in periods ranging from 9 to 13 years. *Caldwell* v. *Campbell*, 218 F. 2d 567.[13] As a consequence of

[13] In its *O'Connor* opinion (Appendix B, *infra*, p. 84), the court stated that the Government conceded, in oral argument that *Caldwell* v. *Campbell*, *supra*, was correctly decided. Such a concession was made only *arguendo* in the court below because of our conviction that, regardless of whether *Caldwell* was correctly decided, the present cases were much closer to *Commissioner* v. *Haden*, 231 F. 2d 340, where a different panel of judges of the Fifth Circuit held that ordinary income was realized where an owner of an oil payment right carved out a smaller oil payment as consideration to the transferee for building a house for the transferor. The court below now seems to explain *Haden* as resting on the ground that the oil payment transfer there was not a sale at all (*O'Connor* opinion, Appendix B, *infra*, pp. 84-87) and thus regards *Caldwell*, rather than *Haden*, as the case which stated generating principles which that court will follow in the future. Because of the Fifth Circuit's explanation of its own decisions, we of course do not concede that *Caldwell* was correctly decided. It should also be noted that, when *Caldwell* was decided, there was then no direct inter-circuit conflict such as now exists (see *supra*, pp. 12-16).

Caldwell and its acceptance by the Tax Court, there is a present tendency for taxpayers to take advantage of those decisions and to formulate transactions accordingly. It has been noted that there has been a recent, "widespread usage" in the oil industry of oil payments "as a device to turn ordinary income into capital gain." 32 Taxes, Tax Magazine, 491, 496 (1954). We are informed by the Internal Revenue Service that, at the present time, this issue is involved in 43 docketed and undocketed cases which, of themselves, represent an estimated loss to the revenue of many millions of dollars if the transferors are held to have realized capital gain rather than ordinary income. And, at least in the Fifth Circuit (where many such cases would probably arise), the decisions below, if not reversed, can be expected to increase substantially the number of transactions and the resulting loss of revenue. In addition, review is justified by the need for resolving the existing conflict between the Fifth and Seventh Circuits (*supra*, pp. 12-16).

CONCLUSION

For the foregoing reasons, it is respectfully submitted that this petition for writs of certiorari should be granted.

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APRIL 1957.

interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 112.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) [as amended by Sec. 115(b) of the Revenue Act of 1941, c. 412, 55 Stat. 687, and Sec. 151(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Capital Assets.*—The term "capital assets" means property held by the taxpayer whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l) * * * or real property used in the trade or business of the taxpayer.

* * * * * *

(4) [as amended by Sec. 150(a)(1) of the Revenue Act of 1942, *supra*] *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the

the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(2) *General rule.* If, during the taxable year the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory involuntary conversion * * * of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 117.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.112(a)-1 [As amended by T. D. 5402, 1944 Cum. Bull. 229]. *Sales or Exchanges.*—* * *

Exceptions to the general rule are made by section 112(b)(1) to (5), inclusive, * * * in the case of certain specifically described exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such

differences are more formal than substantial. As to these, the Internal Revenue Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, an the new property are substantially continuations of the old still unliquidated.

* * * * *

The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Internal Revenue Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

* * * * *

SEC. 29.112(b)(1)-1. *Property Held for Productive Use in Trade or Business or for Investment.*—As used in section 112(b)(1), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class. The fact than any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose, or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate, or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

* * * * *

APPENDIX B

THE TAX COURT OF THE UNITED STATES

P. G. LAKE, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

[24 T. C. 1076]

Docket No. 48684.

(Filed September 20, 1955)

1. Capital Gain—Oil and Gas—Undivided Interest in Minerals in Place Until Production Equaled a Stated Amount.—The petitioner realized long-term capital gain and not ordinary income when in 1950, in consideration of the cancellation of an indebtedness of $600,000, it transferred 25 per cent of seven-eighths of all oil and gas upon two leases owned by it to its creditor until such time as the payments received by the latter equaled the amount of the debt plus interest thereon.

* * * * * *

Harry C. Weeks, Esq., for the petitioner.
Paul M. Newton, Esq., for the respondent.

OPINION.

MURDOCK, *Judge:* The Commissioner determined deficiencies in income tax of $9,060.79 for 1949, $47,459.09 for 1950, and $12,026.24 for 1951 and a deficiency in excess profits tax for 1950 of $65,044.07. Two

issues are presented for decision. One is whether the petitioner realized a long-term capital gain from the sale in 1950 of a portion of an interest in two oil and gas leases. The facts relating to this issue have been fully stipulated and the stipulation on this and the other issue is adopted, together with all exhibits, as findings of fact in this case.

The petitioner is a Delaware corporation which filed its returns for the taxable years with the collector of internal revenue for the second district of Texas. It was engaged in developing oil and gas properties and producing oil and gas.

The petitioner was indebted to P. G. Lake in the amount of $600,000 on December 29, 1950, and on that date, in consideration of the cancellation of that indebtedness, sold and transferred to him 25 per cent of seven-eighths of all oil and gas upon two leases, entitling him to receive that portion of all production from the leases beginning at 7 a.m., January 1, 1951, until he had received $600,000 net to him, plus an amount equal to 3 per cent per annum payable monthly on the unpaid balance of the $600,000. The petitioner had owned the leases for several years prior to December 29, 1950, and had always held them for productive use in its business and not for sale. The petitioner reported the entire consideration of $600,000 as long-term capital gain on its return for 1950, but the Commissioner, in determining the deficiency, held that the $600,000, less the cost of documentary stamps affixed to the conveyance, was ordinary income subject to the allowance for depletion.

It is held that the petitioner correctly reported its gain from this transaction upon authority of the following cases which the Commissioner concedes are

adverse to his contention: *Lester A. Nordan*, 22 T.C. 1132, in which the appeal of the Commissioner to the Court of Appeals for the Fifth Circuit was dismissed on June 8, 1955; *John David Hawn*, 23 T.C. 516, in which the Commissioner's appeal is now pending in the Court of Appeals for the Fifth Circuit; and *Caldwell v. Campbell*, 218 F. 2d 567. See also *Wm. Fleming*, 24 T.C. ——— (July 29, 1955).

Reviewed by the Court.

Decision will be entered under Rule 50.

UNITED STATES DISTRICT COURT

W. D. Texas, Austin Division.

DENNIS M. O'CONNOR and KATHERINE O'CONNOR, Independent Executors of the Estate of THOMAS O'CONNOR, Deceased, and DENNIS M. O'CONNOR, KATHERINE O'CONNOR, MARY O'CONNOR BRAMAN, Joined Herein by Her Husband, D. H. BRAMAN, and THOMAS O'CONNOR, JR., APPELLANTS

v.

FRANK SCOFIELD, Former Collector of Internal Revenue, APPELLEE

[143 F. Supp. 240]

Civil Action 824. March 28, 1956.

RICE, *District Judge*.

This case arises under the provisions of the Internal Revenue Code of 1939, 26 U.S.C.A. § 1 et seq. It involves income taxes together with interest paid by the Estate of Thomas O'Connor, Deceased, for the taxable year ended November 30, 1948.

The above entitled action was tried without jury by the Court in San Antonio, Texas, on November 4, 1955.

The question involved in the case is as follows:

Were the plaintiffs taxable at long term capital gain rates or at ordinary income rates on the gain realized from the sale of an oil payment during the fiscal year ended November 30, 1948, to D. E. Blackburn?

The Court having considered the oral testimony, stipulated facts and the briefs of counsel and being fully advised otherwise in the premises, makes and enters the following findings of fact and conclusions of law.

Findings of Fact

1. Thomas O'Connor died testate in Victoria County, Texas, on December 5, 1946. Plaintiffs Dennis M. O'Connor and Katherine O'Connor, duly qualified as Independent Executors of the Estate of Thomas O'Connor, Deceased, and are now acting in such capacity. Plaintiffs Dennis M. O'Connor, Katherine O'Connor, Mary O'Connor Braman and Thomas O'Connor, Jr. are the sole heirs at law and devisees under the will of Thomas O'Connor, deceased. D. H. Braman is the husband of Mary O'Connor Braman.

2. In the fiscal year of the Estate ended November 30, 1948, to wit, on November 26, 1948, the Executors of the Estate transferred, by general warranty deed, certain royalty interests (subject to a reversionary interest, as hereinafter stated) to D. E. Blackburn of Victoria, Texas, for the cash consideration of $9,990,350. The deed making such transfer was delivered to D. E. Blackburn and duly recorded in the Deed Records of Refugio County, Texas, with some $10,000 in documentary stamps having been attached to the deed. Expenses attributable to the sale

amounted to $10,990. The royalty interests sold to Blackburn had been held by decedent and subsequently by his Estate for many years. The properties sold to Blackburn had been held by plaintiffs in excess of six months.

3. If the gain from the transaction in question is properly taxable as income on the sale of a capital asset held for more than six months, and not as ordinary income, the basis for computing such gain is $1,325,105.81.

4. The above mentioned transaction was consummated on November 26, 1948 and was carried out in accordance with its terms. Blackburn, as owner of the royalty interest, received the money from the companies running the oil from the properties, pursuant to transfer orders executed by plaintiffs to the respective pipe line companies.

5. The deed above referred to provided that after the royalties described therein had produced sufficient oil to pay the purchaser, D. E. Blackburn, the sum of $10,000,000.00 (with interest as computed thereon at the rate of 4% per annum), the properties would revert to the grantors. The aforesaid amount was duly received by Blackburn from said properties during the period beginning January 28, 1949 and ending December 24, 1951. Upon receipt of this amount, Blackburn, the purchaser, pursuant to the provisions in the deed, executed his quitclaim deed, reconveying the royalties to the Estate, which quitclaim was duly recorded in the Deed Records of Refugio County, Texas.

6. Both the sellers and the buyer (D. E. Blackburn) intended the transaction in question to be a sale and purchase of the royalty interests in question. They did not intend to enter into a loan or a mortgage transaction. At no time did the Executors, individually, or in

their fiduciary capacity, make any guaranty or agreement to indemnify the purchaser or enter into agreements with the purchaser other than the agreement to sell, as set forth in the deed. At all times, the risks incident to the presence and production of sufficient quantities of oil to make the transaction profitable for the purchaser were upon the purchaser. The purchaser, D. E. Blackburn, borrowed the purchase money from Chase National Bank of New York, giving his note and a deed of trust on the properties purchased by him. The bank dealt only with Blackburn and looked only to him. The plaintiffs did not have anything to do with Blackburn's bank loan. The transaction in question was real and bona fide and was, in no sense, a sham or a subterfuge. Blackburn made a substantial profit on the transaction and reported and paid tax on his profit.

7. The purpose of the sale of the oil payment was a bona fide business purpose, to wit, to raise money to pay federal estate taxes and state inheritance taxes due by reason of the death of Thomas O'Connor, deceased, and to pay administration expenses of the Estate. The Estate was in need of cash resources with which to pay these charges and for these reasons the oil payment was sold.

8. The sale in question was the first and only sale of oil payments or other mineral interests that the Estate had made until that time. Neither the decedent, Thomas O'Connor, nor his Estate, was in the business of selling oil payments or other mineral interests. The limited royalty interests, the oil payment in question, was not held primarily for sale to customers.

9. The oil payment "paid out" after three years of production, during which the properties were owned by Blackburn. The oil payment would have taken an

appreciably longer period to pay out had it not been for the fact that there was an increase in the production in the field by the operating lessees and had it not been for the further fact that there had been a substantial increase in the price of oil shortly prior to the sale of the oil payment, which higher price was maintained during the period of the pay out.

10. The royalty interest (or oil payments) sold to Blackburn represented a substantial part of the plaintiffs' oil in place. Also, in terms of the relative values of the interest sold and of the reversionary interest retained by the sellers, the transfer represented a substantial part of the sellers' royalty interest.

11. The Executors of the Estate of Thomas O'Connor, Deceased, filed a fiduciary income tax return for the fiscal period ended November 30, 1948, reporting the gain on the sale as ordinary income. This gain was reported as ordinary income because of the ruling of the Commissioner of Internal Revenue, published in 1948, requiring such gain to be so reported. Thereafter, a timely claim for refund was filed, which was rejected (except as to a minor item not here involved), notification of such rejection being received in a registered letter dated March 12, 1953, and subsequently, this suit was brought within the time prescribed by the Internal Revenue Code.

12. There was probable and reasonable cause for the acts done by Frank Scofield, the former Collector of Internal Revenue, acting pursuant to the orders and directions of the Commissioner of Internal Revenue.

Conclusions of Law

1. This Court has jurisdiction of the subject-matter of and the parties to this case.

2. The transaction with D. E. Blackburn was a bona fide sale.

3. The sale to Blackburn was a sale of a royalty interest in producing oil properties in Texas, subject to a reversion to plaintiffs after the royalties had produced in Blackburn's hands the prescribed amount. This was a sale of what is commonly called an oil payment. This oil payment was a real property interest under the law of Texas and, under the tax laws, a property interest in oil in place. The transaction was not intended to be and was not, as a matter of fact or a matter of law, an assignment of income, but was the sale of a property interest to Blackburn, which property interest produced income in the hands of Blackburn. This property interest was substantial and real, representing a substantial part of the grantors' royalty interest. The property so sold was a long-lived, and not a short-lived, oil payment.

4. The property interest so sold to Blackburn was a capital asset as defined in Section 117 of the Internal Revenue Code of 1939, and this capital asset had been held by plaintiffs for more than six months.

5. None of the exceptions in Section 117 or elsewhere in the Internal Revenue Code, denying a transaction long-term capital gain treatment, are applicable to the instant transaction.

6. Plaintiffs are entitled to receive long term capital gain treatment under Section 117 on the sale of the oil payment in question to Blackburn.

7. Judgment shall be entered for the plaintiffs. By reason of the probable cause for the acts of the Commissioner or other officials of the Treasury Department, as found by the Court, the judgment, on becoming final, shall be provided for and paid out of the proper appropriations from the Treasury of the United States.

THE TAX COURT OF THE UNITED STATES

WM. FLEMING and BESSIE M. FLEMING, HUSBAND AND WIFE, ET AL.,[1] PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

[24 T. C. 818]

Docket Nos. 46713, 46781, 46782.

Filed July 29, 1955.

1 and 2. *Exchanges Solely in Kind—Capital Gain—Sec. 117 (j), I. R. C., of 1939.*—Petitioners exchanged oil payments for land. *Held*, that the property was of unlike kind within the meaning of section 112(b)(1), and the gain was taxable as capital gain.

Henry C. Weeks, Esq., for the petitioners.
Daniel A. Taylor, Esq., for the respondent.

OPINION

JOHNSON, *Judge:* Respondent determined deficiencies in income tax as follows:

Docket No.	Petitioner	Year	Deficiency
46713	Wm. Fleming and Bessie M. Fleming	1948	$94,113.30
46781	E. Howard Walsh and Mary D. Walsh	1948	2,301.31
		1949	38,550.52
46782	Mary D. Fleming Walsh	Fiscal year ended 8-31-48	51,976.17
		Fiscal year ended 8-31-49	31,278.55

The issues presented are:

(1) Whether an exchange of limited overriding royalties or oil payment interests for the fee simple

[1] The following proceedings are consolidated herewith: E. Howard Walsh and Mary D. Walsh (husband and wife), Docket No. 46781; Mary D. Fleming Walsh, Docket No. 46782.

title to a ranch was an exchange solely in kind under section 112(b)(1), Internal Revenue Code of 1939. In the alternative, if a gain is recognized, is it a capital gain, or ordinary income with depletion allowable?

(2) Would the tax consequences resulting from the exchange above be different where urban real property is substituted for the ranch?

* * * * * *

Petitioner Mary D. Fleming Walsh has stipulated that she is liable as a transferee for whatever deficiencies in income tax are finally determined against Wm. Fleming, Trustee, for the fiscal years ended August 31, 1948, and August 31, 1949.

All of the facts have been stipulated and are so found and we summarize therefrom as follows:

Wm. Fleming and Bessie M. Fleming were husband and wife, as were F. Howard Walsh and Mary D. Walsh. Mary D. Fleming Walsh (Mary D. Walsh) was also the daughter of Wm. Fleming. All petitioners were residents of Fort Worth, Texas, and their income tax returns were filed on a cash basis with the collector of internal revenue for the second district of Texas.

Issue 1.

For all the years before us Wm. Fleming was the sole trustee and Mary D. Walsh was the sole beneficiary of the private trust known as Wm. Fleming, Trustee. This trust was created in 1931 and continued in existence until 1950. The trust kept its books on a cash basis for a fiscal period ending August 31 of each year, and its income tax returns were filed with the collector of internal revenue for the second district of Texas.

For the years before us the Fleming Oil Company

was a partnership composed of Wm. Fleming and Wm. Fleming, Trustee. The partnership produced oil and gas, and made investments. Wm. Fleming held a 61.026 per cent interest in the business, and Wm. Fleming, Trustee, a 38.974 per cent interest. Partnership books were kept on a cash basis, and tax returns for the partnership were filed with the collector of internal revenue for the second district of Texas.

On May 19, 1948, Marie Hildreth Cline (joined by her husband) conveyed an undivided fee simple title to 2,994.5 acres of ranch land to the Fleming Oil Company (.50 per cent), Wm. Fleming, Trustee (.25 per cent), and Wm. Fleming (.25 per cent). As consideration for this conveyance the grantees of the land conveyed and assigned to Marie Hildreth Cline certain limited overriding royalties or oil payment interests. These limited overriding royalties or oil payment interests came from oil and gas leases, or oil and gas mineral leases, which the transferors had owned for more than 6 months prior to May 19, 1948, for productive use in their respective trades and businesses and not for sale. The ranch was acquired for investment and not for sale.

Pertinent parts of the various oil payments to Marie Hildreth Cline are presented below:

In the first, the Fleming Oil Company, as owner of one-half of seven-eighths of certain oil and gas leasehold estates does hereby sell, assign, and convey unto the said MRS. MARIE HILDRETH CLINE, as a part of her separate property and estate, her heirs and assigns, the following described real property, to-wit:

> An overriding royalty and mineral interest carved hereby out of the interest owned by Fleming Oil Company in each and all of the oil and gas leases

described above, amounting to an undivided 49 128ths interest in and to all the oil in, under, and that may be produced, saved and marketed from the above described tracts of land under the terms of the oil and gas leases covering same, until the grantee named above shall have received therefrom oil of the net value of One Hundred Forty-seven Thousand Dollars ($147,000.00), plus an amount equal to five per cent (5%) interest per annum from May 19, 1948, on the portions of said $147,000.00 which may be unsatisfied from time to time.

This grant was made subject to certain conditions, limitations, and agreements, such as:

(4) No interest in the gas or casinghead gas in, under, or produced and saved from said tracts, and no interest in the personal property now or hereafter placed thereon is assigned or conveyed to grantee, this conveyance affecting the oil only.

(5) When and if the grantee herein, her heirs and assigns have received from the fractional interest hereby assigned, ~~oil or~~ the net value of $147,000.00, plus an amount equal to five per cent (5%) interest as above provided, then the interest hereby conveyed to said grantee shall cease and terminate, and said interest shall revert to, and shall thereafter be owned by grantor, its successors, heirs or assigns; and grantee, her heirs and assigns, shall have no further interest in said oil and gas leasehold estates covering said land, or in the oil thereunder; and grantee, her heirs or assigns, shall,

upon request, execute such instruments as may be necessary or proper to evidence this of record.

(6) The execution of this conveyance shall not impose upon grantor any obligation with respect to developing or operating the property covered hereby, nor shall it be implied herefrom that grantor is in anywise obligated to see that grantee receives oil aggregating the net value of $147,000.00, plus an amount equal to five per cent (5%) interest as above provided, or any lesser sum; but grantor does covenant and agree that grantee shall have the same but no greater right to require grantor to develop and operate said property in accordance with the terms of the original leases upon said property as the original lessors therein, their heirs or assigns, might have or exercise.

Marie Hildreth Cline's share of oil produced from the property described in the Fleming Oil Company assignment, from the effective date of the assignment to the close of 1952, amounted to:

Year	*Amount*
1948	$15,801.16
1949	22,835.94
1950	31,172.41
1951	31,350.19
1952	30,559.54

In the next oil payment, Wm. Fleming, as owner of an undivided interest in certain oil and gas leases does hereby sell, assign, and convey unto the said MRS. MARIE HILDRETH CLINE, as a part of her separate prop-

erty and estate, and to her heirs and assigns, the following described real property, to wit:

> An overriding royalty and mineral interest carved hereby out of the interest owned by Wm. Fleming in each and all of the oil and gas leases described above, amounting to a .166668 interest in and to all the oil in, under, and that may be produced, saved and marketed from the above described tracts of land under the terms of the oil and gas leases covering same, until the grantee named above shall have received therefrom oil of the net value of Seventy-three Thousand Five Hundred Dollars ($73,500.00), plus an amount equal to five per cent (5%) interest per annum from May 19, 1948, on the portions of said $73,500.00 which may be unsatisfied from time to time.

This grant was also made subject to certain conditions, limitations, and agreements. These were similar to those in the Fleming Oil Company assignment. Marie Hildreth Cline's share of oil produced from this property, from the effective date of the assignment to the close of 1952, amounted to:

Year	*Amount*
1948	$5,423.49
1949	9,412.84
1950	7,916.69
1951	4,854.74
1952	6,420.78

The oil payment from Wm. Fleming, Trustee, conveyed to Marie Hildreth Cline the following described interest:

An overriding royalty and mineral interest carved hereby out of the interest owned by Wm. Fleming, Trustee, in each and all of the oil and gas leases described above, amounting to an undivided 6.100ths interest in and to 7 8ths of all the oil in, under, and that may be produced, saved and marketed from the above described tract of land under the terms of the oil and gas leases covering same, until the grantee named above shall have received therefrom oil of the net value of Forty-nine Thousand Dollars ($49,000.00), plus an amount equal to five per cent (5%) interest per annum from May 19, 1948, on the portions of said $49,000.00 which may be unsatisfied from time to time.

Like the other grants, this was also subject to certain conditions, limitations, and agreements. Marie Hildreth Cline's share of the oil produced from this property, from the effective date of the assignment to the close of 1952, amounted to:

Year	*Amount*
1948	$1,436.99
1949	7,365.73
1950	7,423.68
1951	7,793.11
1952	7,730.24

Wm. Fleming, Trustee, also conveyed by a mineral deed certain royalty interests to Marie Hildreth Cline as part consideration for the ranch. In this deed the trust did "grant, sell, and convey unto the said grantee, as a part of her separate property and estate, an undivided .32,3535 100ths royalty interest in and to

all of the oil in, under, and that may be produced from certain real property. The deed further provided:

> Said land being now under an oil and gas lease, it is understood and agreed that this sale is made subject to the terms of said lease, but covers and includes 32.3535 100ths of the 1/8th royalty on oil due and to be paid under the terms of said lease, insofar as it covers the above described land, until the grantee named above shall have received oil of the net value of Twenty-four Thousand Five Hundred Dollars ($24,500.00), plus an amount equal to five per cent (5%) interest per annum from May 19, 1948, on the portions of said $24,500.00 which may be unsatisfied from time to time.

Like the other grants, this was also made subject to certain conditions, limitations, and agreement. Marie Hildreth Cline's share of the oil produced from this property, from the effective date of the conveyance to the close of 1952, amounted to:

Year	*Amount*
1948	$2,306.57
1949	3,393.20
1950	3,913.38
1951	3,985.71
1952	3,248.27

On the tax returns of Wm. and Bessie M. Fleming and the Fleming Oil Company (a partnership), for the calendar year 1948, and Wm. Fleming, Trustee, for the fiscal year ended August 31, 1948, the exchange of the ranch for the oil payments was treated as an exchange of property of like kind under section 112(b)(1). However, respondent determined that they received a

gain from this exchange and adjusted their 1948 income accordingly. Respondent explained this adjustment to Wm. and Bessie M. Fleming's 1948 net income as follows:

> (d) Your gain on the exchange of an oil payment, face amount $73,500.00, plus 5% interest payable out of 40% of 41.067 W. I. in State (Choate) Lease, Eddy County, New Mexico, for a 1/4 undivided interest in 2,994 1/2 acres in Parker and Tarrant Counties, Texas, has been computed as follows:
>
> | | |
> |---|---|
> | Consideration, fair market value of land received, held to be face value of oil payments | |
> | 1/4 of $294,000 | $73,500.00 |
> | Cost basis of oil payment assigned, depletion, 27 1/2%, of $73,500 | 20,212.50 |
> | Income increased | $53,287.50 |

Respondent's determination, tabulated for each of the assignors, is as follows:

	Fleming Oil Co.	Wm. Fleming	Wm. Fleming, Trustee
Fair market value of interest at Choate ranch received	$147,000.00	$73,500.00	$73,500.00
Net cost or basis of property transferred	1,102.70		18,119.21
Percentage depletion allowable to	40,425.00	20,212.50	20,212.50
Net income from exchange received	106,575.00	53,287.50	53,287.50

Since the Fleming Oil Company was a partnership, in the final adjustment respondent distributed the partnership income to the partners; the beneficiary's income from the trust was also adjusted.

The exchanges by Fleming Oil Company, Wm. Fleming, and Wm. Fleming, Trustee, of oil payments out of oil and gas leases situated in the counties of

willingness to purchase a portion of that royalty interest and negotiations followed.

Petitioner and Munro discussed the amount of money petitioner would probably need in later years to pay his taxes, the probable amount of sulphur still in place (which they estimated to be about 35 million tons), the anticipated annual rate of sulphur production, the annual royalty payments which would probably be received by a purchaser of petitioner's interest, the probable amount of time required for pay outs from sulphur production of different sums of money, the discount factor (such as the interest Munro would have to pay on funds borrowed by him to purchase the royalty interest which affected Munro's profit from the transaction, and the tax savings to petitioner.

It was finally agreed that the transaction would be based upon petitioner's anticipated requirements for funds to pay taxes for the succeeding 3 years, and upon a 4-year pay out period from sulphur production to Munro. On this basis, it was determined that petitioner would assign to Munro a portion of his royalty interest on 6,000,000 long tons of sulphur, from which Munro would receive $50,000 within about 4 years, and that, in return, Munro would pay petitioner $46,500 over a 3-year period. Munro advised petitioner that the latter's tax savings resulting from the transaction would be about $1,000 to $4,500 and Munro estimated that his own profit from the transaction (after allowance for the discount factor) would approach $2,000.

On December 24, 1947, petitioner executed a deed conveying to Munro 86.254514 per cent of his pooled royalty interest of $0.009661[illegible] (i.e., $0.00833333) per long ton on 6,000,000 long tons of sulphur to be produced from

Howard, Gregg, and Cooke in the State of Texas and Eddy County, New Mexico, for fee simple title to 2,394½ acres of ranch lands situated in Parker and Tarrant Counties, Texas, were not exchanges of property for property of a like kind and the gains derived therefrom was capital gain.

In this first issue the question is whether the exchange here of limited overriding royalties or oil payment interests for the fee simple title to ranch land was an exchange of "property of a like kind" within the meaning of section 112(b)(1), Internal Revenue Code of 1939.[1] If so, petitioners' gain therefrom should not have been recognized in computing their taxable income, since the parties admit the existence of the other requirements of the section. Petitioners contend the properties were of like kind, while respondent determined that they were not.

Treasury Regulations, in defining the meaning of "like kind" as here used, state that same "have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class." The meaning of the words in there further particularized by citing examples of nontaxable exchanges, which include exchange of "city real estate for a farm or ranch, or a leasehold of a fee with 30 years or more to run for real

[1] SEC. 112. RECOGNITION OF GAIN OR LOSS.

(b) *Exchanges Solely in Kind*

(1) *Property held for productive use or investment.*—No gain or loss shall be recognized if property held for productive use in trade or business or for investment * * * is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment

Boling Dome. In consideration therefor Munro gave petitioner:

Check dated Dec. 24, 1947	$13,000
Promissory note due Dec. 24, 1948, with 6 per cent annual interest after maturity)	16,500
Promissory note due Dec. 24, 1949 (with 6 per cent annual interest after maturity)	16,500
	$46,500

Pertinent portions of the assignment follows:

I, W. F. Weed, in consideration of [$13,000 cash and the two $16,500 notes] * * *, do hereby SELL, TRANSFER and ASSIGN, unto the said Marion F. Munro, * * * 86.25451% of $.00960133 per long ton pooled royalty on sulphur produced by Texas Gulf Sulphur Company at Boling Dome, Wharton County, Texas, from lands and premises described in said above named conveyances [to petitioner from his father and his father's estate], until six million (6,000,000) long tons of sulphur have been produced and accounted for to the said Marion F. Munro therefrom, which royalty so sold and here assigned and conveyed amounts to $.00833333 per long ton.

* * * * * *

This assignment and the royalty transferred and assigned hereby on sulphur produced from Boling Dome, * * * shall continue to be effective until said Marion F. Munro shall have received said royalty on six million (6,000,000) long tons of sulphur and no longer. * * *

The following statement shows the payments made by Munro to petitioner, pursuant to the above conveyances, and the method of financing used by Munro:

estate, or improved real estate for unimproved real estate". See Regs. 111, sec. 29.112(b)(1)-1.

Similar interpretations have appeared in all of the regulations, beginning with Regulations 62, issued under the Revenue Act of 1921. These have all likewise interpreted the term "like kind," and the statute in question has been repeatedly re-enacted by Congress without change since the Revenue Act of 1924. "Under the established rule Congress must be taken to have approved the administrative construction and thereby to have given it the force of law." *Helvering v. R. J. Reynolds Tobacco Co.*, 306 U.S. 110. This regulation has also been uniformly followed and approved by the courts.

Applying the above regulations to the facts here, we do not think the properties in question have the same "nature or character," nor are they of the same "kind or class," hence they are not "of a like kind" within the meaning of the statute.

In comparing properties to determine their likeness within the meaning of section 112(b)(1), we must consider not alone the nature and character of the physical properties, but also the nature and character of the title conveyed or the rights of the parties therein. The accepted legal definition of "property" so contemplates and requires. We quote:

> In law it is not the physical, material object alone which constitutes "property." The term means something more than the mere thing which a person owns. * * *
>
> [73 C.J.S. 138]

The word "property" means not only the thing possessed, that is the physical, corporeal thing, but

also *rights* in the physical, corporeal thing which are created and sanctioned by law. [73 C.J.S. 140; *Texas Co. v. Hamptman*, 91 F. 2d 149 and other cases there cited.]

The rights created in the property determine the character of the property owned.

The above-cited regulation gives recognition to this legal definition of property. In effect it provides that even if both properties exchanged are realty, if there be substantial difference in the rights created in and to the respective properties, then the properties are not of a like kind. Illustrative of this, it provides that a leasehold interest in land cannot be exchanged for a fee title in land without tax consequences, unless the lease has "thirty years or more to run." The implication is clear that the rights created in the respective grantees in and to the properties exchanged must be of the same general character or of substantial equality. If not, then the properties exchanged are not of like kind within the meaning of the Code. It was so held in *Midfield Oil Co.*, 39 B.T.A. 1151, relied upon by respondent, and which sustains his contention here. There it was held that an oil payment limited in amount is different within the meaning of section 112(b)(1) from an overriding royalty which continues as long as production lasts.

The reason there given for holding the properties unlike was because of the real differences in the rights created by the Holman oil payment and the Dawson

[1] This provision of the regulation was discussed and approved in *Century Electric Co.*, 15 T.C. 581, affd. 192 F. 2d 155, certiorari denied 342 U.S. 954. In *Stocks Block Co. v. Maryland Co.*, 15 T.C. 41, it was held a lease for 21 years was not equivalent to a fee

overriding royalty," which were held to be "differences of substance and not of mere form." The rights under the Holmans oil payments were to continue only until a specified sum of money was realized therefrom, while the Dawson royalty rights "continued for so long as oil or gas might be produced from the property."

In the instant case the rights created in the overriding royalties or oil payments were almost identical with those created in the Holmans oil payments, the only difference being the amount in dollars and cents to be paid, but in both, upon completion of payment of the sum specified, the oil interests assigned were to revert to the grantor. *Midfield Oil Co., supra*, was approved and followed by Kay Kimball, 11 B.T.A. 940.

Petitioners cite *Commissioner v. Crichton*, 122 F. 2d 181, affirming *Kate A. Crichton*, 42 B.T.A. 490, where it was held that an exchange of an undivided interest in oil, gas, and other minerals for an undivided fee in a parcel of improved realty was an exchange within the meaning of section 112(b)(1).

That case does not sustain petitioners' contention here. There the mineral interest conveyed was not for a limited period but was an outright and absolute conveyance of the "oil, gas and other minerals in, on and under and that may be produced from" the land therein described. There was no limitation or restriction of any kind. The difference in this respect from *Midfield Oil Co., supra*, is pointed out in the Board of Tax Appeals' opinion in the *Crichton* case, *supra*. (See 42 B.T.A. at p. 492.)

Petitioners rely on *Flemming v. Campbell*, (C.A. 5) 205 F. 2d 549, reversing a United States District Court for the Northern District of Texas case (Sept. 29, 1952). The appellate court in its reversal held that an

exchange of a limited overriding royalty or oil payment solely for a determinable fee in an oil and gas lease was an exchange of property of like kind within the meaning of section 112(b)(1)." Apparently Government Counsel therefore rested their case solely on the ground

> that the mineral interest in the Ector County lands was an interest in fee and that in the Gregg County lands, for which it was exchanged, was a leasehold of a type which does not have thirty or more years to run, and hence that therefore under the regulation the interests exchanged were not of like kind.

The court decided the case on the issue as presented and held that both interests exchanged were interests in minerals in place and hence both were interests in land; further, that neither interest was a "leasehold of a fee" in the sense that term is used in the regulation, and therefore the 30-year provision of the regulation did not apply. The issue there is not present in the instant case and the facts here are wholly different.

Here the exchange was not "mineral interests for mineral interests," but an exchange of a fee simple title, an absolute estate in such land for a limited mineral interest which expired when a definite sum of money was realized therefrom.

Notwithstanding the comprehensive terms of conveyance contained in the assignment of the mineral interest, the ceiling limitation therein, whereby the maximum amount the grantee could ever receive therefrom was a fixed sum of money with interest, strips the extent of grantee's rights therein more in the nature of a mortgagee than that of owner. The grantee's interest

was primarily monetary and of a temporary nature. The grantors at all times owned a residuary title in the mineral property. In any event a temporary title to the oil properties, continuing only until a sum of money is realized therefrom, is not equivalent to an absolute and unconditional title in the ranch land. The rights created were wholly different. The properties here exchanged were not of like kind within the meaning of section 112(b)(1).

Now that we have determined that there was a taxable gain from the exchange, we must ascertain whether it was ordinary income, as determined by respondent, or capital gain, as contended by petitioners. This question must be decided in favor of the petitioners upon authority of *John Wood Hawn*, 23 T.C. 510, *Lester A. Nordan*, 22 T.C. 1132, and *Caldwell v. Campbell, Jr.*, 218 F. 2d 567, from which this case is not distinguishable in principle. See *Walter A. Henshaw*, 23 T.C. 176. These cases hold that an oil payment is a capital asset and the gain derived from the sale or exchange of an oil payment may be given capital gains treatment. Similarly, the petitioners' gain from the exchange of the oil payments is entitled to capital gains treatment. Petitioners are sustained on this question.

In arriving at our conclusion that petitioners' gain was a capital gain, we have considered, but cannot sustain, respondent's contention that petitioners' transaction was the mere assignment of future income in exchange for a ranch.

Issue II.

On October 5, 1949, C. C. Cross conveyed to E. Howard Walsh the fee simple title to certain urban real estate

in Fort Worth Texas. As the sole consideration for this land, F. Howard Walsh conveyed to Cross certain limited overriding royalties or oil payment interests. Walsh's conveyance to Cross was in part as follows:

> F. Howard Walsh, does hereby, subject to the conditions and limitations hereinafter set out, bargain, sell, assign and convey unto C. C. Cross, of Tarrant County, Texas, his heirs and assigns, the following described overriding royalty and mineral interests carved out of the interests owned by the undersigned grantor in and to the oil and gas leases and leasehold estates, insofar as they cover the tracts of land and leases described above, such interests herein conveyed being the following fractional parts of the oil, in, under, or upon, or that may be produced from such tracts of land under the terms of said leases, to wit:
>
> (a) $\frac{1}{4}$ of $\frac{7}{8}$ of such oil, insofar as all of the tracts and leases in Ward County above described are concerned, save and except Walsh's "Killough" Lease; and
>
> (b) $\frac{1}{4}$ of 7/16 of such oil, insofar as such Killough Lease is concerned.
>
> This grant is made subject to the following conditions and limitations, to-wit:
>
> * * * * * *
>
> (c) When and if Cross, or his heirs and assigns, shall have received, under the terms of said conveyance and assignment, oil of the net value of SIXTY-FIVE THOUSAND AND NO/100 DOLLARS ($65,000.00), plus interest at the rate of seven (7) per cent per annum on the balances unpaid from time to time

(exclusive of gross production taxes, which may be deducted from Cross's part of the oil), then Cross shall have no further interest in said oil and gas leases or leasehold estate, and the oil then remaining in, under or upon said tracts of land, or thereafter produced therefrom; and the interests hereby conveyed shall automatically revert to WALSH, his heirs and assigns.

Cross's share of the oil produced from the property named in the conveyance, from the effective date of the conveyance to the close of 1952, amounted to:

Year	*Amount*
1949	$ 3,909.61
1950	22,301.12
1951	22,073.03
1952	21,793.90

On their 1949 income tax return E. Howard Walsh and his wife treated this transaction as an exchange of property of like kind under section 112(b)(1). Respondent determined that the transaction produced ordinary depletable income for them. Respondent also determined that the real estate acquired by Walsh had a market value of $65,000, that the limited overriding royalties or oil payment interest had no basis in Walsh's hands, and that the allowance for depletion was $17,875, with a net income of $17,125 taxable to Walsh and his wife in 1949.

The exchange by E. Howard Walsh of an oil payment out of oil and gas leases situated in Ward County, Texas, for fee simple title to revenue-producing real estate situated in Fort Worth, Tarrant County, Texas, was not an exchange of property for property of a like

kind and the gain derived therefrom is taxable income.

In this issue petitioners F. Howard Walsh and Mary D. Walsh conveyed an oil payment to C. C. Cross for a piece of urban real property. There is no real difference between this exchange and that we discussed in the first issue. Therefore, for the reasons stated in the first issue, petitioners' gain in this issue is taxed like the gain considered in the first issue.

* * * * * * *

Decisions will be entered under Rule 50.

THE TAX COURT OF THE UNITED STATES

JOHN WRATHER and NELL WRATHER, Husband and Wife, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

T. C. Memo. 1955-101

Docket No. 38267

Filed April 26, 1955

Allen E. Pyle, Esq., for the petitioners.

John P. Higgins, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

JOHNSON, *Judge*: Respondent determined deficiencies in petitioners' income tax for 1948 and 1949 in the amounts of $112,715.34 and $72,404.66, respectively.

our recent decisions in *Lester A. Nordan*, 22 T.C. 1132; *John David Hamm*, 23 T.C. 516, now on review in the Fifth Circuit; and other cases which were cited and discussed in the *Nordan* and *Hamm* cases. We think petitioner must prevail on the strength of these authorities, as well as the more recently decided *Caldwell v. Campbell*, (C.A.5) 218 F. 2d 567; *Wm. Fleming*, 24 T.C. (July 29, 1955); and *A. J. Slaughter, Jr.*, 24 T.C. (Aug. 25, 1955). It is true that in the aforementioned cases the mineral interests which were involved were oil payments, whereas here sulphur payments are involved. However, we think that fact makes no difference and that the same rule must be applicable to the sale and transfer of sulphur payments as applies to the sale and transfer of oil payments.[2] We so hold and, following the above decisions, we decide this issue in favor of petitioner. Since those cases adequately discussed the point of law involved it is unnecessary to here repeat the discussion.

In his brief, respondent attempts to distinguish the *Nordan*, *Hamm*, and *Caldwell* cases, all *supra*, upon the grounds that the taxpayers therein transferred their *entire* interests in oil in place, retaining only a reversionary interest therein after satisfaction of the oil payments from the interests conveyed, whereas here petiti-

[2] Cases dealing with minerals other than oil and gas have played their parts in the development of the law applicable to oil and gas. See, e.g., 63 I.D. 22730, 1941-1 C.B. 214, citing *Bankers' Pocahontas Coal Co. v. Burnet*, 287 U.S. 308 (coal). Conversely, we think that those principles stated in oil and gas cases are applicable alike to other minerals, absent evidence of special circumstances compelling a distinction (such as substantial differences in controlling provisions of the Internal Revenue Code). As stated in 63 I.D. 22730, *supra*, at page 219, "Like issues arise in the oil and mineral cases which are cited interchangeably in the evolution of the applicable rules."

The following issues are presented in this proceeding:

(1) Was petitioners' gain from the sale of an oil payment in 1948 ordinary income or capital gain?

Findings of Fact

Some of the facts are stipulated and are incorporated herein by this reference.

John and Nell Wrather, husband and wife, were residents of Longview, Texas. They filed joint tax returns for 1948 and 1949 with the collector of internal revenue for the second district of Texas. John Wrather will hereinafter be referred to as the petitioner.

Issue 1.

Facts. During 1948 and 1949 petitioner, T. W. George, and F. B. Wimberly were partners in a business known as George & Wrather Drilling Company, hereinafter referred to as the partnership.

In 1948 petitioner, George and Wimberly, as partners, held certain oil and gas lease assignments for tracts of land known as the Brown Lease and the Knotts "A" Lease. Both leases were productive and had produced income for the partnership prior to 1948. By a contract dated June 19, 1948, the partners and their wives, as individuals and for the partnerships sold and conveyed to the Indiana Farm Bureau Cooperative Association, Inc., hereinafter referred to as the Cooperative, an oil payment in the amount of $130,000 to be paid out of $\frac{7}{8}$ 10ths of $\frac{7}{8}$ 24ths of $\frac{7}{8}$ 8ths of the oil produced and saved from the Brown Lease. In consideration for this oil payment assignment the Cooperative paid the partnership $125,000 in cash on or about the date of the assignment.

By another conveyance dated June 19, 1948, the partners and their wives, as individuals and for the partnership, sold and conveyed to the Cooperative an oil payment in the amount of $155,000, to be paid out of 9/10ths of 5/16ths of 7/8ths of all the oil produced and saved from the Kieffer "A" Lease.

On August 16, 1948, the partners and their wives conveyed to the Cooperative another $12,500 oil payment out of the Kieffer "A" Lease. In consideration for these oil payments from the Kieffer "A" Lease, the Cooperative paid the partnership $102,500 cash on or about the date of the assignments.

In June 1948 the Cooperative received its first proceeds attributable to the oil payments from both leases. By January 1952, the Cooperative had received $130,000 from the Brown Lease and by June 1953, $167,500 from the Kieffer "A" Lease. The reasonable pay out time on the three interests was calculated at the time of the assignment to be from four to six years.

Opinion. In this first issue the questions of fact have been stipulated and the remaining question of law is whether petitioner's share of the gain from the sale of an oil payment is a capital gain or ordinary income. Petitioner reported the gain as capital gain but respondent determined it to be ordinary income.

The decision in this case is controlled by the decisions in prior cases involving the sale and exchange of oil payments.

In *Orlic Oil Co.*, 57 B.T.A. 656, affd. 162 F. 2d 508, it was held that the grantor of an oil payment realized a taxable gain on the sale of an oil payment. The gain was based on the consideration received for the oil payment, but the court did not discuss the question of whether the gain was capital gain or ordinary income.

In a later case *John David Hawn*, 23 T.C. 516, the Court was required to decide whether the consideration received by Hawn in exchange for an oil payment constituted capital gain or ordinary income. The Court, following *Lester A. Nordan*, 22 T.C. 1132, held that Hawn's conveyance of an oil payment was a transfer of a capital asset, and the gain realized therefrom was taxable as capital gain.

Similarly, it was held by the Court of Appeals, Fifth Circuit, in *Caldwell v. Campbell*, 218 F. 2d 567, where a taxpayer transferred oil payments in exchange for cash and notes, that the oil payments were capital assets. The gain was then held to be taxable as capital gain.

Since the *Hawn*, *Nordan* and *Caldwell* cases have established that oil payments should be treated as capital assets, and since we are unable to distinguish the oil payments in the present case from those in the *Hawn*, *Nordan* and *Caldwell* cases, we must find that the oil payments conveyed by petitioner to the Cooperative were capital assets. Further, since there is no dispute that the properties were held for more than six months, petitioner's gain is taxable as capital gain under section 117 of the 1939 Code.

Decision will be entered under Rule 50.

Slaght et. Ux., all *supra*, reveals that in fact the taxpayers therein did *not* convey their entire interests but, as did petitioner here, carved out the transferred mineral payments from the entire interests which they owned.

Respondent in his determination of the deficiencies has allowed petitioner percentage depletion on the money received from Munro for sale of the sulphur payment. But petitioner was not the owner of the sulphur royalties at the times he received such money from Munro and, therefore, was clearly not entitled (nor does he claim to be so entitled) to any deductions for depletion. See *John David Hawn, supra*.

Having decided the primary issue in petitioner's favor it is not necessary to decide his alternative contention that, if we should hold that his gains from the sale and transfer to Munro are taxable as ordinary income, then it should all have been reported in 1947, the year of sale, and that none should have been reported in 1948 and 1949.

Decision will be entered under Rule 50.

THE TAX COURT OF THE UNITED STATES

W. F. WEED, INDIVIDUAL, AND ESTATE OF LEONARD W. WEED, DECEASED, W. F. WEED, EXECUTOR, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

[24 T.C. 1025]

Docket No. 46312

Filed September 22, 1955.

Held, the gain resulting from W. F. Weed's sale and transfer of a sulphur payment carved out of his pooled royalty interests in sulphur produced from deposits in place, which interests Weed had owned for several years prior to the date of sale, was taxable as long term capital gain on the installment basis and not as ordinary income.

Peter B. Wells, Esq., for the petitioners.

W. B. Rehm, Esq., for the respondent.

The Commissioner has determined deficiencies in petitioners' income taxes as follows:

Year	*Deficiency*
1948	$1,136.79
1949	1,055.70

The deficiency for 1948 is due to the following adjustments:

(a) Disallowed as nontaxable capital gain	$ 1,242.52
(b) Income from sulphur royalty	12,551.00
(c) Net loss not deductible in 1948	2,372.01

Adjustment (b)(1), which is the principal adjustment, is described in the deficiency notice as follows:

> (b) As stated above the amount received for the assignment of a sulphur payment less 23% depletion is included in full in income. See item (d) for reduction of capital gain.

Amount received	$16,300
Less: Depletion, 23%	3,749
Amount taxable	12,551

The petition assigns error only as to adjustment (b) described above. The assignment of error is as follows:

> 4. The commissioner erred in disallowing long term capital gains treatment on the sale of sulphur in place in the ground.

The deficiency for 1949 is based principally upon an adjustment of the same kind and in the same amount as adjustment (b)(1) for 1948, and the assignment of error is the same for 1949 as for 1948. There is also an adjustment for 1949 of $110.67 for disallowance of medical expenses but counsel stated at the hearing that that will be automatically taken care of when we decide the main adjustment in the case.

Findings of Fact

W. F. Wood, sometimes hereinafter referred to as petitioner, resides in Beaumont, Texas. Eleanor M. Wood was petitioner's wife during the tax years 1948 and 1949, and at all other times pertinent hereto. She died testate on August 3, 1952, whereupon, by order of the Probate Court of Jefferson County, Texas, peti-

tioner was appointed independent executor of her estate. He has continued as such to the date of this hearing.

Petitioner and his wife filed joint income tax returns for 1948 and 1949 with the collector of internal revenue, Austin, Texas.

In 1945 and 1946, as principal stockholder, petitioner formed two companies, Pre Fab Building Supply Corporation, and Star Lumber Company, and also formed, as a wholly owned subsidiary of the latter, Planet Lumber Corporation. In 1947, these companies were in need of funds and were not sufficiently sound financially to have adequate credit. In addition, petitioner contemplated the organization of another corporation whose capital requirements would exceed $100,000. Such corporation was actually formed in May 1948, and petitioner did supply most of its capital.

Petitioner in 1947 believed that, in 1948 and the succeeding years, he would need all (or a large part) of the credit which was available to him personally at the banks or through similar sources to obtain funds for use in the carrying on of the aforementioned business enterprises. He therefore desired some assurance that he would have a definite source of funds (other than banks and similar sources) for payment of his individual Federal income taxes due in those later years.

On December 23, 1947, petitioner was the owner of a pooled overriding royalty interest in sulphur produced by the Texas Gulf Sulphur Company from a tract of land referred to as Boling Dome, in Wharton County, Texas.[1] Petitioner's royalty interest entitled him to re-

[1] The Boling Dome tract was composed of a number of parcels of land. The owners of the royalty interests in sulphur produced from each of those individual parcels entered into a pooling agree-

over $1,000,000 of $2 per long ton of sulphur produced from Boling Dome by the aforementioned companies, irrespective of what the market price for such sulphur might be. Royalty payments were made by the Company monthly, based on the previous month's production. Petitioner's $10,000,000 $2 per long ton interest represented the aggregate of three pooled royalty interests, each in a lesser amount, received by petitioner (a) from his father by two inter vivos deeds dated September 1, 1933, and August 15, 1935, respectively, and (b) after his father's death, from the latter's estate by independent executor's deed dated August 1, 1945. Such interest was not held by petitioner primarily for sale to customers in the ordinary course of his trade or business.

In the summer or early fall of 1947, petitioner, Frank C. Taylor (a C.P.A. then retained as accountant for petitioner's personal affairs and who prepared petitioner's 1947 return), and Marion Munro (a C.P.A. then retained by two of petitioner's corporations and who subsequently prepared petitioner's individual joint returns for 1948 and 1949) discussed the problem of petitioner's business commitments and the need for providing some sure source of funds with which to pay petitioner's individual income taxes, especially those due in January 1948. It was suggested that petitioner might sell a portion of his Boling Dome royalty interest, and Munro expressed the opinion that such a transaction would have the advantage of being taxed to petitioner at capital gain rates. Munro indicated a probable

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ment pursuant to which royalties from sulphur produced anywhere in Boling Dome were to be distributed pro rata among all such royalty interest holders. This petitioner's interest is referred to as "pooled."

Date	Munro's payments to petitioner	Munro's loans from First National Bank, Beaumont, Texas			
		Amount	Interest	Date paid	Total amt. paid
Dec. 24, 1947	$11,200	$11,000	[illegible]	$ 20.48	$231.31
Sept. 25, 1948	2,000				
Dec. 20, 1948	14,300	[illegible]	[illegible]	[illegible]	95.14
Dec. 19, 1949		[illegible]	[illegible]	2.20.50	18.75
Dec. 23, 1949	16,500				
Total	$46,500	$25,100			$345.74

Munro's loans from the bank were negotiated by him independently of petitioner and were not guaranteed by petitioner. As security for the loans Munro assigned to the bank the royalty interest purchased from petitioner until such time as all of his loans were paid. Coincurrently with that assignment he notified the Texas Gulf Sulphur Company to make his royalty checks payable jointly to himself and the bank and to mail them directly to the bank. The bank credited the royalty checks received first to the principal and interest due on the above loans and, when that was satisfied, to Munro's personal account. Receipt of royalty checks from Texas Gulf Sulphur Company averaging about $2,000 each from February 28, 1948, until March 20, 1950 (on which date the limited royalty interest on 6,000,000 tons was fully paid out), resulted in its being unnecessary for Munro to borrow more than $11,500 in order to meet the two $16,500 notes due petitioner, since Munro was able to pay, in part, those notes at maturity with royalties received and accumulated prior thereto.

As above indicated the limited royalty interest which petitioner assigned Munro on December 24, 1947, was paid out within 28 months thereafter. In his income tax

returns Munro reported the royalties he received as ordinary income, less cost depletion, in the year of receipt.

Petitioner used the $13,900 received from Munro on December 24, 1947, in paying the January 15, 1948, installment on his 1947 Federal income tax.

Separate individual Federal tax returns for 1947 were filed, on a community property basis, by petitioner and his wife. The above transaction was fully disclosed in those returns, was treated as resulting in capital gain, and the profits therefrom were reported on the installment basis. After adjustments for basis and costs of sale, the profit realized in 1947 from the $13,900 received that year was reported as $13,380.78. Fifty per cent thereof, $6,690.39, was taken into account as a community long-term capital gain and petitioner and his wife each reported half of that sum ($3,345.19) as their community share in the separate returns they filed.

Petitioner and his wife filed joint income tax returns for both 1948 and 1949. In each of those years petitioner received from Munro, pursuant to the terms of the aforementioned transaction, $16,300. In their return for each year they reported, after adjusting the $16,300 for basis, a profit of $15,691.11 on the installment basis, and took 50 per cent thereof ($7,845.56) into account as long-term capital gain.

Opinion

Black, *Judge*: Some of the adjustments made by the Commissioner in his determination of the deficiencies are not contested and these adjustments will be given effect in a recomputation under Rule 50.

The issues which we do have before us are common to both years. Petitioner states the issues in his brief as follows:

> 1. Whether the Commissioner erred in taxing to petitioner as ordinary income for the years 1948 and 1949 proceeds from the 1947 sale of a sulphur royalty and whether such proceeds are long term capital gains and properly reported on the installment basis;
>
> 2. If it be determined that petitioner realized ordinary income from the sale of such sulphur royalty, whether all the proceeds should be reported as ordinary income for the year 1947.

The amounts which petitioner has received in each of the taxable years in return for the limited sulphur royalty (hereinafter referred to as a sulphur payment) which he conveyed to Munro in 1947, are not in dispute. Petitioner, in joint returns filed with his wife, returned the profits from those receipts in each taxable year as capital gain on the installment basis. The Commissioner does not question use of the installment basis in returning the income for taxation nor does he question the accuracy of the amounts of the profits reported. He does question petitioner's right to use the capital gain method and has determined that the gain from the conveyance of the sulphur payment is taxable as ordinary income and not as capital gain. That determination is based on the Commissioner's conclusion that the transaction in issue was an assignment of income itself rather than the conveyance of income-producing property.

In support of the treatment of gains from the transaction as capital gains, petitioner cites and relies upon

tioner conveyed merely a fractional part of his interest in sulphur in place (86.254511 per cent of his pooled royalty interest of $0.009956133, that is to say $0.008333333 per long ton on 6,000,000 long tons of sulphur to be produced) and retained not only a reversionary interest in the fraction conveyed (after satisfaction of the sulphur payment therefrom) but a *continuing* interest in sulphur in place to the extent of $0.001328 per long ton produced. Respondent argues, therefore, that the principle applied in those cases is not here applicable.

We fail to see any merit in this argument. Having once determined in the aforementioned cases that the conveyance of a mineral payment constitutes the transfer of property rather than the assignment of income, we see no distinction in carving out that interest in the manner herein employed by petitioner so long as the transaction itself is bona fide. The only particular in which respondent's argument differs from those made by him in the aforementioned cases is as regards the fractioning and, certainly, it is clear that the conveyance of a fractional part of one's interest in income-producing mineral property is not itself regarded by respondent as resulting in tax treatment different from that which would be applicable if the entire interest were conveyed.[3] Moreover, a careful study of the whole record in *Nordan*, as well as in *Wm. Fleming* and *A. J.*

[3] In G.C.M. 12218, XII-2 C.B. 119, respondent stated that a taxpayer's unlimited conveyance, with no retained reversion, of a fraction of his royalty interest (e.g., conveyance in fee of one-eighth of a one-eighth overriding royalty) may be treated as the sale of a capital asset. Similarly, in I.T. 4003, 1950-1 C.B. 10, 11, respondent's apparent position is that the assignment of an oil payment (representing a fraction of the taxpayer's interest but extending over the entire life of the mineral property) may be treated as the sale of a capital asset.

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 16126

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

versus

P. G. LAKE, INC., RESPONDENT

Petition for Review of Decision of The Tax Court of the United States

(February 1, 1957)

Before HUTCHESON, Chief Judge, and HOLMES and BORAH, Circuit Judges.

HUTCHESON, Chief Judge. This appeal by the commissioner from one of a series of adverse decisions[1] of the Tax Court presents the single question whether $600,000 received as consideration for an assignment of overriding oil payment interests limited to $600,000 carved out of two oil and gas leaseholds or working interests[2] is taxable to the seller as ordinary income sub-

[1] Lake v. Commissioner, 24 T.C. 1016; Fleming v. Commissioner, 24 T.C. 818; Wrather v. Commissioner (not officially reported); Wood v. Commissioner, 24 T.C. 1025; and Slagter v. Commissioner, 24 T.C. 934 (7 Cir.).

[2] The respondent is a Delaware corporation with its principal office in Tyler, Texas, engaged in the business of producing oil and gas, and on Dec. 29, 1950, it owned the 7/8 working interest in two commercial oil and gas leases from which it, as the operator, was then, and for several years had been, producing oil in substantial quantities.

On Dec. 29, 1950, respondent was indebted to P. G. Lake in the amount of $600,000, and on that date, in consideration of the can-

ject to depletion rather than, as the Tax Court held, as long term capital gains under Sec. 117 of the 1939 Internal Revenue Code.

Here vigorously assailing the decision of the Tax Court in this and the other cases, on the ground that they were all based on the premise that all oil payment assignments constitute sales of capital assets entitled to capital gains treatment under Sec. 117, and declaring, "That premise was specifically rejected in the Hawn case", the commissioner thus continues:

> "In the present case, as in some of the other appealed cases, the assignor was a leasehold owner which created the oil payment right not just, like the taxpayer in Hawn, the owner of a larger oil

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cellation of that indebtedness, it sold and transferred to Lake "such an interest in said oil and gas leases * * * so that the said P. G. Lake, Grantee, shall own twenty-five percent of seven-eighths of all oil and gas in, under, or upon such leases and each of them and shall be entitled to receive 25 percent of 7/8 of all the oil, gas and other minerals produced, saved, and marketed from the above described oil and gas leases and leasehold estates, from and after 7:00 a.m., January 1, 1951, until said Grantee, his heirs and assigns, shall have received by virtue of this interest the sum of $600,000 net to him * * *"

The assignment also assured that he should have a royalty owner's status, that is that his 25 percent of the 7/8 of the working interest should be free and clear of any development or production expenses.

It finally provided that after grantee had received the full net sum of $600,000, with interest as provided, from the proceeds of the sale of said 25 percent of 7/8, the conveyance shall terminate and the interest assigned "shall revert to and revest in the grantor, its successors and assigns, and grantee shall execute and deliver an instrument of reconveyance of said interest, and any such other papers as may be necessary to replace the title in grantor".

On Dec. 29, 1950, it could have been estimated with reasonable accuracy that it would require three years or more for the leases to produce oil and gas of the value in amount to which grantee was entitled in the assignment. The actual pay out period was from Jan., 1951, to February, 1954, a little over three years.

payment right. For that reason, the case calls for an even more basic application of the anticipatory assignment of income rule than did Hawn. Not only that, any attempt to treat the oil payment assignment as a 'sale of property according to ordinary property law concepts merely confirms the conclusion that it was an anticipatory assignment of income.

"Our position here in no way conflicts with this court's decision in Caldwell v. Campbell, 218 F(2) 567 where * * * the assigned oil payment rights were carved out of royalty interests * * * ".

Having thus, as he thinks, cleared the ground for an all out and unembarrassed attack on the Tax Court's ruling, the commissioner assails it: (1) as contrary to our decision in Hawn's case in that it treats as substantial an interest which, under the teachings of that decision, is insubstantial; (2) in that what was here transferred was not any part of the leasehold interest, the "property representing income producing property, the vendor's capital investment.", it was a transfer merely of a right to receive future income and, under the teachings of *Burnet* v. *Harmel*, 287 U.S. 22, and the Corn Products case, 350 U.S. 46,[52] it was not entitled to Sec. 117 preferential treatment; (3) in that, if contrary to No. (2) above, the oil payment is treated as a

[52] "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by Sec. 117 applies to transactions in property which are not the normal source of business income. It was intended 'to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.' Burnet v. Harmel, 287 U.S. at 106."

sale of income producing property, it had not been held for six months because it did not come into existence until the oil payment was created; and (4) in that the property sold was the oil itself and thus was property "primarily held for sale in the ordinary course of business", and specifically excluded from capital gains treatment.

In reply to these contentions, respondent, insisting that all prerequisites to long term capital gains treatment, if there was a sale of "property" or "real property used in the trade or business" within Sec. 117 I.R.C. of 1939, are here present, urges upon us that whether or not there was such a sale here is ruled by *Ortiz Oil Co.* v. *Commissioner*, 102 F(2) 508 and *Caldwell* v. *Campbell*, 218 F(2) 567, and not by *Commissioner* v. *Hawn*, 231 F(2) 340.

Arguing that the first two cases treat similar transactions to these as sales, that the Hawn case is clearly distinguishable and that petitioner's arguments have heretofore been rejected by this court in *Caldwell* v. *Campbell*, respondent points out that a glance at the table of cases in commissioner's brief and in the brief of Collector Campbell in *Caldwell* v. *Campbell* will show that commissioner's opposing arguments here are but an expanded repetition of those advanced in that case.

Insisting that the transaction under consideration was an assignment of a part of respondent's property interests in the two leases, the respondent cites in support *Commissioner* v. *Fleming*, 82 F(2) 324; *Colorado Oil & Gas Co.* v. *Commissioner*, 118 F(2) 459; *Thomas Peckham Oil Co.* v. *Commissioner*, 115 F(2) 685; *Lee* v. *Commissioner*, 126 F(2) 825; and *Fleming* v. *Campbell*, 205 F (2) 549.

They recall also that the Supreme Court of the United States, this court, the Supreme Court, and the Intermediate Appeal Courts, of Texas[1] have held that oil and gas leases, royalty interests, overriding royalty interests, and oil payments are interests in land, and that the Texas courts have held that these interests are subject to ad valorem taxes, to statute of frauds treatment as real estate, and in cases of intestacy pass as real estate.

On the commissioner's general position that oil payments carved out of working interests differ from royalties so carved, respondent, quoting from *Tennant v. Dunn*, *supra*, at page 290:

> "The interest assigned or conveyed by the instrument is in the nature of an overriding royalty. The assignment gives to Mrs. Dunn, as the reservation of an ordinary overriding royalty gives to or retains in the grantor or assignor, the right to a certain quantity of oil taken from the land, delivered as it is produced, free of charges or expenses of production or operation. * * * It is our opinion that the instrument under consideration conveys an interest in the land * * * "

points to the uniform course of decision that oil payments are in law and in fact of the same nature, indeed are identical, with royalties, except that a royalty is not limited as to duration and an oil payment is.

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[1] Waggoner Estate v. Wichita County, 273 U.S. 113; Thomas vs. Perkins, 301 U.S. 655; cases cited in footnote 2 (p. 568) of Caldwell v. Campbell, 218 F(2) 565; Sheffield v. Hogg, 124 Tex. 290; 77 SW(2) 1021; Stephens County v. Mid-Kansas Oil & Gas Co., 113 Texas 160; 254 S.W. 290; W. T. Waggoner Estates v. Sigler Oil Co., 118 Texas, 509; 19 SW(2) 27; Tennant v. Dunn, 130 Texas, 285.

To commissioner's third contention that respondent did not have the requisite six months holding period for the oil payment interest conveyed, *a contention on its face requiring the wholly untenable postulate that respondent, in and by the act of conveying the oil payment, acquired it*, respondent points to its complete refutation in the stipulation that *respondent had owned and held the leases for productive use in its trade or business of producing oil and not for sale for several years prior to* Dec. 29, 1950, and to the fact that it is obvious that what respondent conveyed, and the only thing that it could convey, was a part of the estate which it acquired in the acquisition of the leases.

As to his fourth contention, that, in assigning an interest in the leases, *respondent did not assign any part of the property held by it for producing income but assigned merely the oil, the property held for sale in its daily business*, and that this must be *so because the interest of any oil payment owner is only in the oil as personal property*, respondent quotes from the leading case of *Tennant* v. *Dunn*, *supra*, in which, after stating that the particular instrument in question in that case, which carved an oil payment out of a working or lease-hold interest, *did not purport to convey oil in place*, and that the ultimate right of Mrs. Dunn was a right to a certain quantity of oil after it was produced from the well, the same to be delivered to her free from any charges for production or operation, went on to say:

> "*It does not follow, however, that the instrument does not create an interest in land or that it evidences merely a debt to be paid out of oil produced. The oil and gas leases operated to invest the lessee with a determinable fee in the oil and gas in place.*

* * *The instrument above set out under which Mrs. Dunn claims follows the form ordinarily used by a lessee in assigning or conveying an interest in the leasehold estate.* It is not a promise to pay money. *It is not a contract for the sale and delivery of oil, as personalty after production, but it undertakes to invest the assignee, and we think it invests her, presently with a right or interest in what the assignor owned.* * * * *A part of the lessee's right or interest is assigned,* not a fractional interest in the entire leasehold estate but the absolute right, without charges for production or operation, to a fractional part of the oil as and when it is produced from a well on the leased land until the assignee has received oil of the total value of $25,000. *The total quantity of oil to be delivered to the assignee is not a fixed fraction of the entire production and is not a certain number of barrels, but it is measured by value according to a specified standard.* (p. 290) * * * "*The gist of the opinion in Sheffield v. Hogg is that oil and gas royalties, whether payable in kind or in money,* * * * *should be adjudged to be present interests in land rather than merely rights in personalty at some uncertain date, because they are profits arising out of land and further because such classification, which accords with the practice in the oil and gas industry furnishes a stability highly important, if not essential to the structure of the business.* * * * (p. 292.)

"The fact that Mrs. Dunn's purchase of the interest was highly speculative and that she might realize either nothing or very large profits does not affect the nature of the interests. Most invest-

ments in oil properties or production are speculative. Mrs. Dunn did not become by virtue of the assignment a mining partner or a joint adventurer, *for it gave her, not merely a part of the profits of the enterprise, but an interest in land, free of charges for development or operation and without obligation to share in losses;* and under the assignment she had no right to engage, and did not in fact engage, in the operation of the leased land or of the well. * * * " (p. 294) (all emphasis supplied.)

Finally, it is respondent's position that in the light of the views above expressed, this court is bound by the settled law of the cases, including particularly *Ortiz Oil Co.* v. *Commissioner*, 102 F(2) 508; *Fleming* v. *Commissioner*, 205 F(2) 549; *Caldwell* v. *Commissioner*, 218 F(2) 568; and *Commissioner* v. *Hawn*, 231 F(2) 340; and the cases they cite and rely on, to hold that the tax court was right and its judgment must be affirmed.

For the reasons hereafter stated, we find ourselves in complete agreement with these views.

Taking up the grounds put forward by the commissioner for reversal and rejecting, on the stipulated facts, note 2, *supra*, and for the reasons fully stated in *Scofield* v. *O'Connor*, . . . F(2) . . . just decided, the first ground that this court's decision in Hawn's case requires a contrary holding to that made below, we take up to consider in their turn the second, third, and fourth grounds.

These grounds, as we think we shall show, while put forward by the commissioner as presenting new and sound reasons for persisting in his contention that a sale of oil payments is not a sale of capital assets entitled to capital gains treatment, merely give a super-

ficially new look to and faultfully reargue the old contention. This is accomplished by basing the new argument upon a series of unfounded assumptions as to, and the failure to recognize, the already settled state of the law on the matters discussed.

It is, of course, not conclusive against the commissioner's arguments put forward here for the first time in support of his unyieldingly held and persistently urged general contention, that sales of oil payments are not entitled to capital gains treatment, that they have been put forward in this form in no prior litigations or in the Tax Court in the cases under review here.

It is, however, significant that the profound discovery announced and urged for the first time on this appeal, that the sale of an oil payment carved out of a working interest in its legal aspects differs from the sale of an oil payment carved out of an oil interest, has heretofore escaped the attention of judges, lawyers, text writers, and commentators. As far as our information or observation goes, none of the many litigations arising out of or connected with oil payments, none of the decisions, state or federal, dealing with oil payments carved out of a leasehold estate and holding that they are in the nature of overriding royalties, none of the many textbooks, law reviews, or briefs which have dealt with oil payments, have drawn the distinction the commissioner now seeks to draw between oil payments carved out of leasehold interests and those carved out of royalty interests.

This significance is heightened by the fact that the commissioner, as we understand, concedes that overriding royalty interests carved out of working interests or to which working interests are subject are in nowise

different from royalty interests reserved to or granted by the owner of the fee.

In short, a careful consideration of the long and involved arguments put forward in the briefs in these cases in support of the commissioner's new look and view make it plain we think that, *viewed not as proposals for legislation*, in which case wholly different considerations would apply, but as restatements of the law of the decided cases, they rest on demonstrably false premises whose discovery and exposure they cannot survive.

The first of these premises is that the assignment of an oil payment carved out of a leasehold estate is not an assignment of a part of the interest conferred by the lease, a premise precisely refuted in Dunn's case. This premise repeated and affirmed over and over stems from the failure of the commissioner to understand, or his unwillingness to recognize, the nature of such an oil payment, a refusal or failure having nothing to do with the substance and reality of the transaction under review, or with the decisions in point." It arises in

"It does not follow, however, that the instrument does not create an interest in land or that it evidences merely a debt to be paid out of oil produced. The oil and gas leases operated to invest the lessee with a determinable fee in the oil and gas in place. * * * The instrument above set out under which Mrs. Dunn claims follows the form ordinarily used by a lessee in assigning or conveying an interest in the leasehold estate. It is not a promise to pay money. It is not a contract for the sale and delivery of oil, as personalty after production, but it undertakes to invest the assignee, and we think it invests her, presently with a right or interest in what the assignor owned. * * *".

"* * * we have directed attention to the fact that the interest assigned to Mrs. Dunn, if not in principle the same as a royalty, particularly an overriding royalty, is very like it. We believe we may take judicial knowledge of the common practice in the industry as to the method of paying royalties or other interests in oil

short, entirely out of his giving the word "payment" its dictionary meaning where used alone as the satisfaction of a debt or obligation, instead of in the phrase "oil payment" the clearly understood meaning as a part of a technical descriptive phrase used in conveying carved out interests in oil, a meaning which the decisions have ascribed to and fixed for it when used in the connection under consideration here.

An examination of the many cases, federal and state, which have dealt with oil payments, shows that, without varying, the courts have treated alike oil payments whether carved out of the working or the royalty interests, and that the so-called distinction between them, which the commissioner urges here, has never been made before.

It is, we think, completely fallacious to say that an oil payment carved out of a leasehold interest stands any differently in law from an oil payment carved out of a royalty interest, and it is only by the repetition of the incorrect statement, that they do stand differently, that the argument is, or can be, called an argument.

The commissioner's new approach, therefore, that in this case, because the oil payment was carved out of a working interest, there was not a sale of income producing property, a part of the leasehold interest, but merely of oil as personal property after it is produced, is seen to be in complete contradiction of the law of the cases.

Many owners of royalties and like interests have no facilities for receiving oil, and the ordinary practice is that the owners of such interests, whether payable in oil or in money, obtain payment in money after executing division orders to pipe line companies or other purchasers of the oil." Tennant vs. Dunn, 130 Texas, at p. 294.

Equally fallacious is the commissioner's fourth point, that, assuming that he is correct in contending that the sale of the carved out oil payments was not the sale of a capital asset, held for production of income but was an anticipatory sale of the income itself, what respondents sold, though a capital asset, is merely the oil itself, "property held primarily for sale", and therefore, the sale comes within the express exception from Section 117.

In the first place, the Supreme Court of Texas, in *Tennant* v. *Dunn*, *supra*, saying "*It is not a contract for the sale and delivery of oil as personalty after production*, but it undertakes to invest the assignee, and we think it does invest her, presently with a right or interest in what the assignor owned" (emphasis supplied), expressly negatives the commissioner's contention that royalty payments are conveyances of the oil as personalty.

In the second place, it is no more sound to say that the carving out of an oil payment out of a working interest and the sale of the oil payment thus carved is a sale of the oil as personalty, than it is to say that the carving of a royalty out of a working interest and its sale is such a sale, and no one, not even the commissioner, has yet been heard to claim that the carving of a royalty out of a working interest places the owner of the leasehold estate in the position of merely selling the oil itself as personalty and, therefore, that the sale was, within the Sec. 117 exception, of property held primarily for sale. Indeed, the Commissioner concedes that "an oil payment assignment may sometimes constitute the sale of a capital asset as where a person who owns only an oil payment right sells the entire right." Thus, as applied to the case at bar, though

according to the commissioner the taxpayer did not sell Lake a capital asset. Lake somehow acquired one, and if he later sold the whole of what he bought, the purchaser from him would acquire a capital asset, a truly remarkable result.

The commissioner does not enlighten us on whether in the purchaser's hands the oil which Lake would receive from year to year on the wasting capital asset so acquired would be subject to depletion, but we must assume that it would not, since, contrary not to some but to all of the cases on depletion, the commissioner has concluded here that this putative capital asset was depletable in a lump sum in favor of respondent in the year of the sale, even though not a barrel of the oil had been then drawn.

Of the commissioner's third contention, that the sale was not of property held for more than six months, it is sufficient to say that the parties have stipulated, and the facts show, that the properties out of which the interest was carved had been held for more than that time and that the commissioner's contention, that the property sold came into existence with, and only with, its assignment, is contrary to legal principles indeed, is little short of legal legerdemain.

This brings us at last to what in our opinion is the crowning inconsistency of the commissioner's whole argument. This is that the government, through the commissioner, has the right and power to remake or reinterpret their contract for the parties, so that, though, according to the teachings of all the cases,[5] the

[5] Some of these are: Anderson v. Helvering, 319 U.S. 404; Burnet v. Harmel, 287 U.S. 103; Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25; Caldwell v. Campbell, 218 F(2)c 567; Kirby Petroleum Co. v. Commissioner, 326 U.S. 599.

assignee and not the assignor of a mineral interest, under instruments like those here, is entitled to take depletion on it, the commissioner can by his intervention deprive the assignee of his contract right to depletion in the years following and require the assignor to take it all in the year of the sale before the right to it has arisen. Of course, if the instrument transferred an economic interest in the oil, the commissioner cannot do this.

The Court of Appeals for the Seventh Circuit recognized this in the Slagter case in which treating the arrangement there made as a loan and a dedication of the assigned interest in the oil properties to the repayment of that loan, it is held that the assignors were taxable on the transaction not when they obtained the cash paid for the assignment but that the "income in question was taxable as ordinary income of the taxpayers (assignors) as it accumulated and was paid from time to time to Ashland, and that the tax liabilities should be computed for the years in question upon the amounts thus realized and paid to Ashland in the respective periods."

While we incline to the view that, in its opinion in the Slagter case, the Court of Appeals did not give full effect to the true nature of a limited overriding royalty or oil payment interest as announced in *Thomas* v. *Perkins*, 301 U.S. 655, *Anderson* v. *Helvering*, 310 U.S. 404, *Caldwell* v. *Campbell*, *supra*; and numerous other decisions of this court, it is not necessary for us to determine whether the case was or was not correctly decided on its facts. It is sufficient to say of it that nothing said in it or in its result gives any aid or comfort to, or in anywise supports the contention of the commissioner, as applied to the facts

of this case, and that we are of the clear opinion that the decision of the Tax Court was right and should be AFFIRMED.

A True Copy: Teste:

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Clerk of the United States Court of Appeals for the Fifth Circuit.

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 16253

FRANK SCOFIELD, Former Collector of Internal Revenue, APPELLANT

versus

DENNIS M. O'CONNOR and KATHERINE O'CONNOR, Independent Executors of the Estate of THOMAS O'CONNOR, Deceased, and DENNIS M. O'CONNOR, KATHERINE O'CONNOR, MARY O'CONNOR BRAMAN, Joined by her husband, D. H. BRAMAN, and THOMAS O'CONNOR, JR., APPELLEES

Appeal from the United States District Court for the Western District of Texas

(February 1, 1957)

Before HUTCHESON, Chief Judge, and HOLMES and BORAH, Circuit Judges.

HUTCHESON, *Chief Judge*: One of several appeals[1] from judgments entered in favor of taxpayers, after

[1] Fleming v. Commissioner, 24 T.C. 818; Wrather v. Commissioner, . . . T.C. . . .; Weed v. Commissioner, 24 T.C. 1025; Lake v. Commissioner, 24 T.C. 1016.

Caldwell's case [2] and before Hawn's case [3] had been decided here, this appeal presents the single question whether, in the light of those cases, a transaction involving oil payments carved out of royalty interests was, as claimed by the taxpayer and found by the trial court, a sale of a capital asset, or was, as claimed by the commissioner, an anticipatory assignment of income.

Making no attack upon Caldwell, in fact conceding in oral argument that it was correctly decided, appellant's whole effort is directed to bringing us into agreement with his contentions: that in Hawn's case this court *held* that, though Congress had provided no standard or guide, this and other courts, by the use of a kind of slide rule method not clearly if at all revealed in the decision, could, in their uncontrolled discretion, determine as a fact in each case whether a sale of an oil payment interest is or is not too insubstantial to qualify for capital gains treatment under Section 117; and that, in the exercise of this fact finding power, we should hold as a fact that, because of the insubstantialty of the transaction, the sale made here was not a sale.

It is taxpayer's position: that this court did not in Hawn's case in anywise qualify or limit Caldwell; that it particularly did not hold that, without a legislative standard to guide its decision, it had the power to determine in each case, as a fact, whether an assignment would or would not be regarded as insubstantial; and, finally, that Hawn's case was decided not on the ground of the factual insubstantiality as such of the property purportedly sold, but on the ground that the facts as a whole did not in law show a sale of property at all but only a loan arrangement.

[2] Commissioner v. Caldwell, 218 F(2) 567
[3] Commissioner v. Hawn, 231 F(2) 341.

In support of its view that the court did not intend to lay down any slide rule method of factually determining in each case the insubstantiality of a transfer, but that the case was determined on the ground that, upon its whole facts, what took the form of, was not in fact and in law, a sale, the taxpayer points to the decisive holding of the court:

> "* * * The agreements showed that the parties contemplated using the oil payments over the next two years for the construction of a house for Hawn. * * * The effect was the same as though Hawn had borrowed the funds required, using the oil payments as collateral, and applied the proceeds of such loans to pay the contractor, and then repaid his loans as the oil payments were received. * * *"

So pointing, he urges upon us that since, as was held in that case, there was no sale but only a loan transaction, the court did not, as the commissioner urges it did, establish, or even undertake to establish, a slide rule for determining insubstantiality as to a bona fide sale, which, upon the stipulated facts and the findings of the trial court, the sale in question here was.

It is true that this court, thus properly deprecating the absence of legislative guide or standard:

> "Although it might be better if congress[1] provided the answer, in the absence of a congressional determination, it devolves on the court to supply it."

[1] The Mills Bill, H.R. 9559, dealing prospectively with oil payment sales and related transactions, introduced in the last congress but not passed, illustrates the desirability of legislation to bring about certainty and clarity in this important area of the tax law.

did state that, along with other facts going to the legal effect of the transaction as a whole, the court should determine "whether such transfer is for a substantial interest in the total property owned by the transferor."

It is equally true, however, that it did not undertake to decide the Hawn case on, or in it lay down, any quantitative rule or other guide, fractional or otherwise, for the factual determination by the court in that or any other case as to what would or would not be substantial. Neither did it undertake to hold that if, instead of a fictional or pretended sale, as the court found that the purported sale was, there had been a real sale of an oil payment of $115,000, the court would have been authorized to hold or would have held, that it was insubstantial in amount and, because and only because thereof, it was not a sale.

To the contrary, stating:

> "It is clearly true, as already indicated, that an oil payment like royalty is an interest in property, an interest in realty, and an interest in minerals in place."

and declaring:

> "Deciding, as we do, that not every transfer of oil payments, even for a valuable consideration, amounts to a sale of capital assets under Sec. 117, it becomes necessary for us to determine whether, under the established principles, this transaction was or was not such a sale."

the court went on to say:

> "Upon careful review of the cases and equally careful consideration of the circumstances of this particular transaction, we conclude that this was not such a sale but was rather an assignment of

anticipatory income which remained taxable to the respondent."

This is to say that the court, correctly concluding, on the whole facts, not that there was a bona fide sale which, because in amount it was insubstantial, did not come within Section 117, but that this was not a sale at all, it was a credit arrangement, which, though in form an assignment of the oil interest it purported to deal with, was in fact and in law nothing but an anticipatory assignment of income made as security for, and in payment of, Hawn's debt to the contractor, as correctly *held* that the course of dealings did not amount to a sale or exchange of capital assets under Section 117.

We, therefore, agree with the taxpayer that if, as commissioner contends, this court in the Hawn case did, and we should, without a legislative standard or guide, determine as matter of fact whether and where a time limit was to be drawn upon whether a sale of oil payments was substantial or insubstantial enough to constitute a sale entitling taxpayer to capital gains treatment, the result would be not deciding but mere fiating, or, at best, unwarranted judicial legislation.

If, however, on the other hand, as the Hawn case held and we hold, the court in each case takes all of the facts into consideration for the purpose of determining whether, as matter of law, a transaction was or was not a sale of capital assets, so as to entitle it to capital gains tax treatment under Sec. 117, the court would only be following and applying the rule laid down in the cases, that not every sale of capital assets, but only those which in law come under the statute, will support capital gains treatment,[3] and that it would be running a good princi-

[3] Rudco Oil & Gas Co. v. United States, 82 Fed. Supp. 746, "a case", as we pointed out in Caldwell v. Campbell, 218 F(2) 570, "of a corporation dealing deviously through its stockholders * * *".

ple into the ground if a taxpayer would be allowed to claim as a sale of capital assets, the daily use of small portions thereof in connection with his business and the payment of his day to day expenses."

That the transaction in this case was not of an insubstantial kind is shown by the fact that it involved a cash sale for $9,990,350 of an oil payment conveying 4,000,000 barrels of oil in place, and by the undisputed facts and the oral testimony of two witnesses, the government's brief stating, "The oral testimony in uncontradicted and accordingly there are no disputed facts".

It is further shown by the definite and precise findings of the district court, which, after setting out the full transaction, categorically and specifically found that the transaction was a bona fide and effective sale.[7]

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* * * "It was in effect a mere appointment of the stockholders to receive the mineral income of the corporation for sixty or ninety days of the taxable year in which the purported transfer was made. It was therefore a completely abortive attempt, like those dealt with in the Horst, the Harrison and the Eubank cases, to change the statutory rule for the taxation of income by appointing one to collect as his own the income of another."

[6] Cf. what is said by the Supreme Court in Burnet v. Harmel, 287 U.S. 103, argendo and by decision, and in Corn Products Co. v. Commissioner, 350 U.S. at page 52:

"* * * Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by Sec. 117 applies to transactions in property which are not the normal source of business income. It was intended to relieve the taxpayer from * * * excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions." Burnet v. Harmel, 287 U.S. at 106."

[7] "Both the sellers and the buyer (D. E. Blackburn) intended the transaction in question to be a sale and purchase of the royalty interests in question. They did not intend to enter into a loan or a mortgage transaction. At no time did the Executors, individually or in their fiduciary capacity, make any guaranty or agree-

Based upon these findings of fact, he concluded as matter of law:

"The transaction with D. E. Blackburn was a bona fide sale.

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ment to indemnify the purchaser or enter into agreements with the purchaser other than the agreement to sell, as set forth in the deed. At all times, the risks incident to the presence and production of sufficient quantities of oil to make the transaction profitable for the purchaser were upon the purchaser. The purchaser, D. E. Blackburn, borrowed the purchase money from Chase National Bank of New York, giving his note and deed of trust on the properties purchased by him. The bank dealt only with Blackburn and looked only to him. The plaintiffs did not have anything to do with Blackburn's bank loan. The transaction in question was real and bona fide and was, in no sense, a sham or a subterfuge. Blackburn made a substantial profit on the transaction and reported and paid tax on his profit.

"The purpose of the sale of the oil payment was a bona fide business purpose, to-wit, to raise money to pay federal estate taxes and state inheritance taxes due by reason of the death of Thomas O'Connor, deceased, and to pay administration expenses of the Estate. The Estate was in need of cash to correct with which to pay these charges and for these reasons the oil payment was sold.

"The sale in question was the first and only sale of oil payments or other mineral interests that the Estate had made, until that time. Neither the decedent, Thomas O'Connor, nor his Estate, was in the business of selling oil payments or other mineral interest. The limited royalty interests, the oil payment in question, was not held primarily for sale to customers.

"The oil payment 'paid out' after three years of production, during which the properties were owned by Blackburn. The oil payment would have taken an appreciably longer period to pay out had it not been for the fact that there was an increase in the production in the field by the operating lessees and had it not been for the further fact that there had been a substantial increase in the price of oil shortly prior to the sale of the oil payment, which higher price was maintained during the period of the pay-out.

"The royalty interest (or oil payment) sold to Blackburn represented a substantial part of the plaintiffs' oil in place. Also, in terms of the relative values of the interest sold and of the reversionary interest retained by the sellers, the transfer represented a substantial part of the sellers' royalty interest."

"The sale to Blackburn was a sale of a royalty interest in producing oil properties in Texas, subject to a revision to plaintiffs after the royalties had produced in Blackburn's hands the prescribed amount. This was a sale of what is commonly called an oil payment. This oil payment was a real property interest under the law of Texas, and, under the tax laws, a property interest in oil in place. The transaction was not intended to be and was not, as a matter of fact or a matter of law, an assignment of income, but was the sale of a property interest to Blackburn, which property interest produced income in the hands of Blackburn. This property interest was substantial and real, representing a substantial part of the grantors' royalty interest. The property so sold was a long-lived, and not a short-lived, oil payment.

"The property interest so sold to Blackburn was a capital asset as defined in Sec. 117 of the Internal Revenue Code of 1939, and this capital asset had been held by plaintiffs for more than six months."

It will serve no useful purpose for us to set out here the undisputed facts on which the findings and conclusions were based. It will be sufficient to say that, on the record made, the district judge was right and his judgment should be AFFIRMED.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Fifth Circuit.

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 15981

WM. FLEMING and BESSIE M. FLEMING, (Husband and Wife), F. HOWARD WALSH and MARY D. WALSH, (Husband and Wife) and MARY D. FLEMING WALSH, PETITIONERS,

versus

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

versus

WM. FLEMING and BESSIE M. FLEMING, (Husband and Wife), F. HOWARD WALSH and MARY D. WALSH, (Husband and Wife) and MARY D. FLEMING WALSH, RESPONDENTS.

Petitions for Review of Decisions of The Tax Court of the United States (District of Texas)

(February 1, 1957)

Before HUTCHESON, Chief Judge, and HOLMES and BORAH, Circuit Judges.

HUTCHESON, Chief Judge: These consolidated appeals brought by the taxpayers and commissioner, respectively, from decisions of the Tax Court,[1] involve income taxes for 1948 and 1949.

[1] 24 T.C. 818.

Three issues,[2] corresponding to the issues decided below, are presented for review, Issues Nos. 1 and 2 on the taxpayers', and Issue No. 3 on the commissioner's petition.

Submitted on stipulated facts,[3] there were findings in accordance therewith, and a decision against taxpay

[2] These are: (1) The taxpayers exchange limited overriding royalty or oil payment interests (carved by them out of larger oil and gas interests) for, in one case, a ranch; and, in the other, urban business property.

The question is whether the exchanged properties were of "like kind" within the purview of Sec. 112(b)(1) Internal Revenue Code of 1939, so that, all other requirements of said section being met, no taxable gain from the exchanges is to be recognized.

(2) Taxpayer, Mrs. Walsh, in 1943, agreed with a life insurance company that the proceeds of a 10 year endowment life insurance policy on her life, maturing in 1945, "should, after such maturity, be held by the insurance company for an indefinite period of time, not within her control, and, during the first ten years of this extended period, improved with interest, after which interest on the total amount was to be paid to her periodically for the remainder of her life and thereafter as she directed in the agreement.

The question is whether the amounts of the interest improvements in 1948 and 1949, not paid or subject to withdrawal in those years, were nevertheless constructively received during said years by Mr. and Mrs. Walsh "cash basis" taxpayers.

(3) If the first question presented by the taxpayers is decided adversely to them, then should the Tax Court's holding that said exchanges produced long-term capital gain be affirmed, or should the Commissioner be sustained in his contention that the taxpayers merely assigned future income and thereby received ordinary depletable income.

[3] Those pertinent to the first and third issues may be thus summarized:

All of the tax returns involved were filed upon the cash receipt and disbursement basis. Wm. Fleming, the partnership, Fleming Oil Co., Wm. Fleming, Trustee, and F. Howard Walsh, and each of them, were, among other activities, engaged in the business of producing oil and gas. All of the oil and gas properties held by any of those just named and involved in this proceeding had been held by them for several years for productive use in their said trade or business and not for sale.

On May 19, 1948, the Flemings acquired from Mrs. Cline, in the

ers on the two issues appealed by them, and in their favor on the issue appealed by the commissioner.

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proportions of 50%, 25% and 25% the fee simple title to some 2994.5 acres of ranching land situated in Parker and Tarrant Counties, Texas, and hereafter held said lands for investment and not for sale.

The sole consideration given Mrs. Cline for this ranch was the assignment to her by the Flemings of limited overriding royalty or oil payment interests in various producing oil and gas properties then owned by the respective transferors, and by the terms of the transfer Mrs. Cline became entitled to various fractions of the oil thereafter to be produced from the properties until she had received from the Fleming Oil Company assignment oil of the value of $147,000, from the Wm. Fleming assignment oil of the value of $73,500, from the two Wm. Fleming Trustee assignments oil of the value of $49,000 and $24,500, respectively, plus the same interest factor in all. One of the Trustees' oil *payment assignments was out of leasehold interests, the other out of a royalty interest.*

The assignment from Fleming Oil Co. is typical and only its pertinent terms will be set out. It involved four ordinary commercial oil and gas leaseholds in which Fleming Oil Company was then the owner of an undivided one-half interest; and recited that for a valuable consideration Fleming Oil Company conveyed to Mrs. Cline:

> "The following described real property, to-wit, An overriding royalty or mineral interest carved out of the interest owned by Fleming Oil Company in each and all of the oil and gas leases above described, amounting to an undivided 48/128 interest in and to all of the oil in, under and that may be produced, saved and marketed from the above described tracts of land under the terms of the oil and gas leases covering the same, until the grantee above named shall have received therefrom oil of the net value of $147,000, plus an amount equal to 5% interest per annum from May 19, 1948, on the portions of the said $147,000 which may be unsatisfied from time to time."

The instrument further provided that no interest in gas, casinghead gas or in the personal property then on or thereafter placed upon the property was conveyed; that grantee was to be entitled to receive the amount specified from the fractional part of the oil conveyed in addition to such gross production or severance taxes as might be imposed thereupon; that the conveyance was effective June 1, 1948; that all development and operating costs and expenses were to be borne by Fleming Oil Company; and that, when the

On their first question, taxpayers plant themselves firmly on two decisions of this court, *Commissioner* v. *Chrichton*, 122 F (2) 181, holding that a city lot and min

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grantee had received oil of the net value specified, her interest was to terminate. The instrument also provided:

> "The execution of this conveyance shall not impose upon grantor any obligation with respect to developing or operating the property covered hereby, nor shall it be implied herefrom the grantor is in anywise obligated to see that grantee receives oil aggregating the net value of $247,000, plus an amount equal to 3% as above provided, or any lesser sum; but grantor does covenant and agree that grantee shall have the same but no greater right to require the grantor to develop and operate said property, in accordance with the terms of the original lease upon said property, as the original lessors therein, their heirs or assigns, might have or exercise".

On Oct. 5, 1949, taxpayer F. Howard Walsh, in accordance with an existing agreement so to do, acquired from one C. C. Cross the fee simple title to revenue producing business real estate located in Fort Worth, Texas, and as the sole consideration for this conveyance, conveyed to Cross a limited overriding royalty or oil payment interest out of some six producing oil and gas leases in which Walsh then owned interests. The conveyance was in terms substantially similar to the terms of the Fleming Oil Company conveyance just summarized and entitled Cross to the specified fractions of oil, when, as and if produced, until he had received, free and clear of all costs and expenses, oil of the value of $65,000, plus an amount equal to interest on monthly declining balances at the rate of 7% per annum. Walsh acquired and has held the aforesaid business property for investment and not for sale. All of the oil and gas leases involved were ordinary commercial oil and gas leases.

The properties acquired by the respective taxpayers in these exchanges had a fair market value equal to the face amount of the respective oil payments conveyed therefor.

It could be estimated at the time the case was submitted to the Tax Court that the oil payment assigned by Fleming Oil Co. would pay out in approximately 5 years and 8 months from its effective date; that from Wm. Fleming, in from 10 to 12 years from its effective date; and each of the oil payments assigned by Wm. Fleming, Trustee, in from 7 to 8 years from their respective dates. Likewise, it could have been estimated that the F. Howard Walsh oil payment would pay out in approximately 3½ years from its effective date.

eral interests, and *Fleming* v. *Campbell*, 205 F(2) 548, holding that oil payments and perpetual mineral or royalty interests, were properties of like kind. Insisting

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Those pertinent to the second issue are:

The other issue presented involves Mr. and Mrs. Walsh only, and as to this issue the record discloses that on March 28, 1935, Mrs. Walsh (then Mary D. Fleming) acquired from Southwestern Life Ins. Co. a 10 year endowment policy in consideration of ten annual premiums of $2,245.75 each, which were duly paid. The policy provided that if the insured lived to the policy's maturity (March 28, 1945) the insured might within 31 days after such maturity select one of the following options of settlement:

1. $25,000 in cash;
2. $16,400 in cash and a paid up policy for $25,000; or
3. A paid up policy for $72,825.

On September 15, 1943 — some year and a half before the policy matured — Mrs. Walsh entered into an agreement with the insurance company by which, at the maturity of the policy, the payment of the $25,000 proceeds was to be deferred —

"* * * until paid as herein provided:

"Interest on the unpaid portion of such sum at the guaranteed rate of three and one-half per cent per annum, and such additional interest, if any, as may be apportioned thereto by the Company from surplus interest earnings, shall be added to the principal on March 28, each year, until March 28, 1955, and thereafter paid monthly as it accrues, subject to the limitation hereinafter specified, the first payment to be made April 28, 1955. Such interest shall be paid to me, if living, otherwise to the payee or payees as hereinafter designated."

There followed in the agreement provisions for payment after Mrs. Walsh's death to her children and grandchildren, and the instrument concluded —

"It is understood and agreed that the Agreement to be issued and dated March 28, 1945, pursuant to this request, cannot be changed or amended, but the beneficiary may be changed with the consent of William Fleming, my father, upon written request and proper endorsement thereon. All payments provided herein shall be payable at the Home Office of the Company in the City of Dallas, Texas."

In accordance with this, on March 28, 1945, the Life Insurance Company issued an instrument acknowledging the maturity of the policy and that in satisfaction of the obligations of the policy it —

that these cases, holding in accordance with long standing regulations that the statutory phrase "like kind" refers to the nature or character of the property interest and not to its grade or quality, they urge upon us that the exchanged properties, mineral interests for ranch lands in the Fleming transfers and mineral interests for urban real estate in the Walsh transfers, were of like kind.

The tax court judge, though agreeing that the oil payment assignments constituted mineral interests and, therefore, interests in land, was of the opinion that, because the duration of these mineral interests was measured by and limited to oil of the value named in the assignments, the properties exchanged were not of like kind. In short, holding that one was an unlimited, the other a limited, interest in lands, he thought that the sufficient distinction between this and the Crichton case was that the mineral interest exchanged for urban lands there was an unlimited, and not a limited, mineral interest. He thought that the Fleming case could be distinguished because, while it involved a limited mineral interest, a limited overriding royalty

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"Promises to pay at its Home Office in the City of Dallas, Texas the proceeds of said policy in accordance with the option method of settlement selected by Mary D. Fleming Walsh, the insured, in writing, a photostatic copy of such election being hereto attached and made a part hereof."

Nothing was paid to Mrs. Walsh, or anyone else, by the insurance company under said settlement agreement, during the years 1948 and 1949, and Mr. and Mrs. Walsh reported no income from that source in those years. But in determining the deficiencies due by Mr. and Mrs. Walsh for 1948 and 1949 the Commissioner treated as interest income constructively received by them $2,132.18 and $2,206.81, respectively; these amounts being the amounts added to the principal due under the interest provision above quoted from the settlement agreement.

or oil payment, the exchange there was of that interest solely for undivided fractional oil, gas and other mineral interests. To which the taxpayers reply that if, as was held in the Chrichton case, the exchange of an unlimited mineral interest for urban property was an exchange of like kind and in the Fleming case that an exchange of limited, for unlimited, mineral interests was also an exchange of like kind, it must follow, upon the principle that things equal to the same thing are equal to each other, that any of the properties involved in the two exchanges, if exchanged for any involved in the other, would result in exchanges of like kind.

On this issue, Judge Borah dissenting, we agree with taxpayers.

In *Commissioner* v. *Chrichton*, 122 F(2) 181, we pointed out that the invoked section, 112 (b)(1), is so general in its terms as to render an interpretative regulation appropriate and that the Treasury regulation invoked and sought to be applied was appropriate and valid.

In *Fleming* v. *Campbell*, 205 F(2d) at p. 549, quoting in the margin from the Chrichton case,[1] we rejected the argument of the collector "that the mineral interest in the Ector County lands was an interest in fee and that in the Gregg County lands, for which it was exchanged, was a leasehold of a fee which does not have thirty or

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[1] * * * * the regulation and the interpretation under it, leave in no doubt that no gain or loss is realized by one, other than a dealer, from an exchange of real estate for other real estate, and that the distinction intended and made by the statute is the broad one between classes and characters of properties, for instance, between real and personal property. It was not intended to draw any distinction between parcels of real property however dissimilar they may be in location, in attributes and in capacities for profitable use." Com. v. Crichton, 121 F(2) at p. 182.

more years to run, and that, therefore, under the regulation the interests exchanged were not of like kind", saying:

> "We cannot agree. In the first place, both interests exchanged were interests in land, (citing in note 5 many cases). In the second place, neither interest was a 'leasehold of a fee' in the sense in which that term is used in the regulation. Both were interests in minerals in place. Both were therefore interests in land, interests not in personal but in real property, in short, real rights."

We are, therefore, of the opinion that, in those two cases, this court, in principle, decided the question presented here, and that, upon the authority of those decisions, the judgment of the tax court on the first issue must be reversed.

If we assume that we are in error in this view, and we, therefore, reach the third issue, note 2, *supra*, raised on the commissioner's appeal, that the tax court erred in holding that the transactions were exchanges of property giving rise to capital gains treatment and not anticipatory assignments of income, we find ourselves in agreement with the tax court, and, for the reasons set out in *Scofield* v. *O'Connor* and *Lake* v. *Commissioner*, this day decided, we affirm its judgment on this issue.

We come then to a consideration of the taxpayers' second issue, raised by the Walsh appeal, that the tax court erred in holding that the amounts added in 1948 and 1949 under the amended contract with the insurance company, though not paid to taxpayers in those years, were subject to taxpayers' withdrawal and

therefore, constructively received: The tax court, stating:

> "Petitioner [Mrs. Walsh] has deliberately turned her back on income, and has in effect selected the year in which she will report it. This she may not do. Further, the whole arrangement for the nonacceptance of income was voluntary on petitioner's part, she was in no way forced to surrender her right to the proceeds of the matured policy, and she could have had the interest paid to her currently as she did in the second agreement."

concluded:

> "Petitioner, a cash basis taxpayer, cannot escape income tax by directing that accrued interest be accumulated for her benefit in the future. See Theodore R. Bayard, 16 T.C. 1345. * * * "

Here taxpayers insist that the commissioner and the tax court misunderstand the nature and effect of Mrs. Walsh's agreement and the law applicable thereto. Pointing out that under a valid and binding agreement made some eighteen months before the maturity of the policy and effecting a novation of the original agreement, the parties changed the terms of their contract, the taxpayers, citing *Commissioner* v. *Oates*, 207 F(2) 711 as precisely in point, insist that the commissioner and the court are undertaking to make for parties, who were competent to make and had made a valid agreement, an agreement that they did not make.

Pointing to the difference between the facts of this case and those dealt with in our case of *Williams* v. *United States*, 219 F(2) 523; that there the taxpayer

gained nothing by his agreement for the voluntary escrow of moneys admittedly due and payable to him, except, if the plan was successful, a reduction of his taxes and that this court correctly held that moneys so voluntarily escrowed by him were constructively received by him in the year of the escrow; whereas, in this case, there was a real contract in which both contracting parties obtained benefits; taxpayers insist that the Williams case is not against, but is in support of, their contention.

We agree with taxpayers' contention. In the Williams case, the district judge and this court held that the transaction was not an installment sale but a completed one, the gain from which was immediately available and, therefore, taxable, to the seller in the year of its making, and the taxpayer could not, by voluntarily escrowing the purchase price under an agreement that he should receive it in installments, defer payment of the taxes due on the sale.

There is nothing in this record indicating anything other than arms length business transactions between Mrs. Walsh and the company, a contract maturing in 1945, and an agreement entered into eighteen months before its maturity by which, instead of receiving the whole sum in 1945, she agreed with the company that it would hold the funds until 1955, another ten years, adding to the principal amount each year interest at an agreed figure plus such additional amounts as might be appropriated each year from the life insurance company's excess earnings. As a result of the agreement, the amount of the interest added to the principal in 1948 and 1949 was greatly in excess of the guaranteed rate of $3\frac{1}{2}$ percent. In short, in 1943, when her new

contract was made, Mrs. Walsh contracted for a greater rate than would have otherwise been available to her if she had continued to receive only current interest payments. In the years before this court, 1948 and 1949, Mrs. Walsh not only received nothing, she had no right to receive anything.

The judgment against taxpayers on this issue must be reversed.

The judgment of the tax court is AFFIRMED on the commissioner's appeal. On the taxpayers' appeal, it is REVERSED and the cause is REMANDED for tax redetermination in accordance herewith.

Judge Borah dissents from the decision on the first issue note 2 *supra*.

A True Copy. Teste:

Clerk of the United States Court of Appeals for the Tenth Circuit.

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 16055

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

versus

JOHN WRATHER and NELL WRATHER, Husband and Wife, RESPONDENTS

Petition for Review of Decision of The Tax Court of the United States (District of Texas)

(February 1, 1957)

Before HUTCHESON, Chief Judge, and HOLMES and BORAH, Circuit Judges

HUTCHESON, Chief Judge: This appeal from an unreported decision of the Tax Court on stipulated facts,[1]

[1] Briefly and adequately stated, they are:

In 1948 the George & Wrather Drilling Company, a partnership, of which the taxpayer, John Wrather, was a member, sold and conveyed to the Indiana Farm Bureau Cooperative Association, Inc. (hereinafter called COOP) three oil payments carved out of their interests in two oil and gas leases which had been held by the partnership for more than six months. One was for $130,000, payable out of 9/10 of 7/24 of 7/8 of all of the oil produced and saved from the Brown Lease; the others were for $155,000 and $12,500, respectively, payable out of 9/10 of 5/16 of 7/8 of all of the oil produced and saved from the Kieffer "A" Lease.

As consideration for these assignments, COOP paid the partnership $287,500 cash which was treated by the partners on their tax returns as gain from the sale of capital assets. The oil payment out of the Brown Lease paid out in a period of 4 years and the oil payments out of the Kieffer "A" Lease paid out in a period of 5 years, 5 months.

and findings by the Tax Court in favor of respondents, presents the single question whether the Tax Court erred in holding that taxpayer John Wrather's share of the proceeds received from the sale by a partnership, of which he was a member, of oil payments carved out of leasehold estates owned and operated by it was long term capital gain under Sec. 117, rather than ordinary income subject to depletion.

Here the commissioner advances the same contentions and arguments which, at greater length, he advanced in *Commissioner* v. *Lake* and *Fleming* v. *Commissioner*, this day decided, while the respondents here oppose to them substantially the same contentions and arguments advanced by the respondents in those cases.

Referring to, without restating the considerations upon, and the reasons for, which, rejecting the commissioner's, and sustaining the taxpayer's, contentions, we conclude that those cases had been correctly decided below, it is sufficient for us to hold that, upon those same considerations and for the same reasons, we conclude that this case was correctly decided and that the decision and order appealed from should be AFFIRMED.

A True Copy. Teste:

Clerk of the United States Court of Appeals for the Fifth Circuit.

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 16105

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

versus

W. F. WEED, INDIVIDUAL, AND ESTATE OF ELEANOR M. WEED, DECEASED, W. F. WEED, EXECUTOR, RESPONDENTS.

Petition for Review of Decision of The Tax Court of the United States (District of Texas).

(February 1, 1957.)

Before HUTCHESON, Chief Judge, and HOLMES and BORAH, Circuit Judges.

HUTCHESON, Chief Judge: This appeal is from a decision of the Tax Court, 24 T.C. 1025, holding that gain resulting from taxpayer's sale and transfer of a sulphur payment carved out of his pooled royalty was taxable as long term capital gain.

It presents the single question whether the proceeds received by taxpayer from the transfer of a sulphur payment carved out of his $.0096613 per long ton pooled royalty interest, which he had owned for years, consisting of approximately 86 percent thereof, effective until the assignee shall have received 6,000,000 long tons of sulphur and no longer, which was expected to pay out within four years but actually paid out in 28 months, constituted ordinary income subject to de-

pletion rather than, as the Tax Court held, capital gain under 1939 Code, Sec. 117.

Here, contending that this case is clearly controlled by, and requires the same result as that reached in, *Commissioner* v. *Hawn*, 231 F(2) 340, and urging that the transfer of a sulphur payment carved out of royalty has no better status than the transfer of an oil payment so carved, the commissioner insists that the transfer was not effective as a sale of capital assets because it was not of a substantial part of the total property owned by taxpayer assignor.

The taxpayer, pointing out that the Texas courts have determined that mineral payment rights in Texas are real property interest [1] and that that view has been consistently held by the Texas Courts, appropriate United States Courts of Appeals,[2] and the United States Supreme Court, which, in *Thomas* v. *Perkins*, 301 U.S. 655, determined the nature of an oil payment for income tax purposes and established the rule that an oil payment creates an economic interest in the mineral in place, insists that under the undisputed facts of this case,[3] fully set out in the opinion of the Tax Court, to which reference is here made, the transaction

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[1] Sheffield v. Hogg, 24 Tex. 290, Tennant v. Dunn, 130 Texas, 285; A. W. Walker, Jr., "Oil Payments", 20 Texas Law Review, p. 259.

[2] Lee v. Commissioner, 126 F(2) 825; Fleming v. Campbell, 205 F(2) 549; Ortiz Oil Co. v. Commissioner, 102 F(2) 508; to which may be added Caldwell v. Campbell, 218 F(2) 567 and Commissioner v. Hawn, 231 F(2) 340.

[3] Briefly summarized, these are:

Dec. 23, 1947, taxpayer Weed owned a pooled overriding royalty interest in sulphur produced by the Texas Gulf Sulphur Company from a sulphur deposit in Wharton County, Texas, known as Boling

constituted the bona fide and effective sale of a substantial mineral interest entitling it to capital gains treatment.

Upon the considerations advanced by the Tax Court and for the reasons set out by us in *Scofield* v.

Dome; this interest entitled him to receive $.00966133 per long ton of sulphur produced

At the same time taxpayer was supplying funds and credit for a number of companies of which he was principal stockholder, and anticipated he would need all of the bank credit available to him for these enterprises. Further, he realized that, in addition, he needed a definite source of funds for payment of his individual federal income taxes.

In the fall of 1947, taxpayer negotiated with Munro for the realization of these funds, and transferred to Munro 86.254514% of taxpayer's pooled royalty interest of $.00966133 (i.e. $.0083333) per long ton on six million tons of Boling Dome sulphur in exchange for $13,900.00 cash and two notes of $16,300.00 each; the six million tons of sulphur were produced 28 months thereafter.

The taxpayer disclosed the transaction fully in his 1947 tax return, treating the proceeds as capital gains and reporting the profits on the installment basis. Taxpayer's 1948 and 1949 returns reported the $16,300 received from Munro for each such year as long term capital gain. The Commissioner determined that the 1948 and 1949 payments were taxable as ordinary income, subject to depletion. The Tax Court held these proceeds were realized from the sale of a sulphur payment and constituted capital gain.

The following are the pertinent portions of the assignment:

"I, W. F. Weed, in consideration of [$13,900 cash and the two $16,300 notes] * * * do hereby SELL, TRANSFER, and ASSIGN, unto the said Marion F. Munro, * * * 86.254514% of $.00966133 per long ton pooled royalty on sulphur produced by Texas Gulf Sulphur Company at Boling Dome, Wharton County, Texas, from lands and premises described in said above named conveyances [to petitioner from his father and his father's estate] until 6,000,000 long tons of sulphur have been produced and accounted for to the said Marion F. Munro therefrom, which royalty so sold and here assigned and conveyed amounts to $.0083333 per long ton.

* * * * * * * * *

"This assignment and the royalty transferred and assigned hereby on sulphur produced from Boling Dome * * * shall continue to be effective until said Marion F. Munro shall have received said royalty on 6,000,000 long tons of sulphur and no longer.

O'Connor, this day decided, we agree with the respondents and with the Tax Court that the gain in question constituted not ordinary income subject to depletion but capital gain.

The Tax Court's decision is therefore AFFIRMED.

A True Copy. Teste:

Clerk of the United States Court of Appeals for the Fifth Circuit.

JUDGMENT

Extract from the Minutes of February 1, 1957.

No. 16126

COMMISSIONER OF INTERNAL REVENUE

versus

P. P. LAKE, INC.

This cause came on to be heard on the petition of Commissioner of Internal Revenue for a review of a decision of the said Tax Court of the United States, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby, affirmed.

JUDGMENT

Extract from the Minutes of February 1, 1957.

No. 16253

FRANK SCOFIELD, FORMER COLLECTOR OF INTERNAL REVENUE,

versus

DENNIS M. O'CONNOR and KATHERINE O'CONNOR, Independent Executors of the Estate of THOMAS O'CONNOR, Deceased, and DENNIS M. O'CONNOR, KATHERINE O'CONNOR, MARY O'CONNOR BRAMAN, Joined by her Husband, D. H. BRAMAN, and THOMAS O'CONNOR, JR.

This cause came on to be heard on the transcript of the record from the United States District Court for the Western District of Texas, and was argued by counsel;

On consideration whereof, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

JUDGMENT

Extract from the Minutes of February 1, 1957.

No. 15981

WM. FLEMING and BESSIE M. FLEMING, (Husband and Wife), F. HOWARD WALSH and MARY D. WALSH, (Husband and Wife) and MARY D. FLEMING WALSH,

versus

COMMISSIONER OF INTERNAL REVENUE

COMMISSIONER OF INTERNAL REVENUE

versus

WM. FLEMING and BESSIE M. FLEMING, (Husband and Wife), F. HOWARD WALSH and MARY D. WALSH, (Husband and Wife) and MARY D. FLEMING WALSH.

This cause came on to be heard on the petitions of Wm. Fleming and Bessie M. Fleming (Husband and Wife) and F. Howard Walsh and Mary D. Walsh, (Husband and Wife) and Mary D. Fleming Walsh, and Commissioner of Internal Revenue for a review of decisions of The Tax Court of the United States, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court that the judgment of the said Tax Court on the Commissioner's appeal in this cause be, and the same is hereby, affirmed; and on the Taxpayers' appeal, that said judgment be, and it is hereby, reversed; and the cause is remanded to the said Tax Court for tax redetermination in accordance with the opinion of this Court.

"BORAH, Circuit Judge, dissents from the decision on the first issue note 2 supra."

JUDGMENT

Extract from the Minutes of February 1, 1957.

No. 16055

COMMISSIONER OF INTERNAL REVENUE

versus

JOHN WRATHER and NELL WRATHER
Husband and Wife.

This cause came on to be heard on the petition of Commissioner of Internal Revenue for a review of a decision of The Tax Court of the United States, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court that the decision and order of the said Tax Court appealed from in this cause be, and the same is hereby, affirmed.

JUDGMENT

Extract from the Minutes of February 1, 1957.

No. 16105

COMMISSIONER OF INTERNAL REVENUE

versus

W. F. WEED, INDIVIDUAL, AND ESTATE OF ELEANOR M. WEED, DECEASED, W. F. WEED, Executor

This cause came on to be heard on the petition of Commissioner of Internal Revenue for a review of a

decision of the said Tax Court of the United States, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby, affirmed.

Office - Supreme Court, U.S.
FILED
MAY 21 1957
JOHN T. FEY, Clerk

No. 108

In the Supreme Court of the United States

OCTOBER TERM, 1956

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

P. G. LAKE, INC.

FRANK SCOFIELD, FORMER COLLECTOR OF INTERNAL REVENUE, PETITIONER

v.

DENNIS M. O'CONNOR AND KATHERINE O'CONNOR, INDEPENDENT EXECUTORS OF THE ESTATE OF THOMAS O'CONNOR, DECEASED, AND DENNIS M. O'CONNOR, KATHERINE O'CONNOR, MARY O'CONNOR BRAMAN, JOINED BY HER HUSBAND, D. H. BRAMAN, AND THOMAS O'CONNOR, JR.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WM. FLEMING AND BESSIE M. FLEMING (HUSBAND AND WIFE), F. HOWARD WALSH AND MARY D. WALSH (HUSBAND AND WIFE), AND MARY D. FLEMING WALSH

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN WRATHER AND NELL WRATHER, HUSBAND AND WIFE

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

W. F. WEED, INDIVIDUAL, AND ESTATE OF ELEANOR M. WEED, DECEASED, W. F. WEED, EXECUTOR

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY TO BRIEFS IN OPPOSITION

J. LEE RANKIN,
Solicitor General,
CHARLES K. RICE,
Assistant Attorney General,
ELLIS N. SLACK,
MELVA M. GRANEY,
Attorneys,
Department of Justice, Washington 25, D. C.

In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 921

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

P. G. LAKE, INC.*

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY TO BRIEFS IN OPPOSITION

1. While taxpayers (*O'Connor* Br. 9–11; *Lake* Br. 23–26; *Wrather* Br. 7–8)[1] assert that the decisions below are not in conflict with the Seventh Circuit's decision in *Commissioner* v. *Slagter*, 238 F. 2d 901, they offer no adequate explanation. They argue that *Slagter* held that there was "not a sale at all." This argument, however, ignores the Seventh Circuit's express admonition that it was not concerned "with State decisions as to property rights" (p. 903). In *Slagter*,

*Together with *Scofield* v. *O'Connor, et al.*; *Commissioner* v. *Fleming, et al.*; *Commissioner* v. *Wrather, et al.*; *Commissioner* v. *Wood, et al.*

[1] *Wood* opposes the granting of the writ but has waived the right to file a brief in opposition. The *Fleming* brief in opposition is devoted to an argument relating to the preliminary question there involved.

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as in these cases, "The decisive question is whether the transaction, when viewed in the light of federal legislation, amounted to a sale of capital assets or merely to an assignment of anticipatory income" (p. 903). It is this issue—whether the transactions are within not only the letter but also the intent of Section 117 of the 1939 Code (see *Burnet* v. *Harmel*, 287 U. S. 103; *Corn Products Co.* v. *Commissioner*, 350 U. S. 46, 51-52)—upon which the court below and the Seventh Circuit reached directly conflicting decisions.

The *O'Connor* brief erroneously implies (pp. 9-10) that the Government's arguments in the oil payment cases have been uniformly rejected by the judges who have passed upon them. Apparently overlooked are the three Seventh Circuit judges who decided *Slaughter*, the six Tax Court judges who dissented in *Hawn*, the three Fifth Circuit judges who decided *Hawn* and the dissenting judge in *Caldwell*. In fact, the decisions below and the decision in *Hawn*, together with the dissent in *Caldwell*, suggest a possible divergence of view within the Fifth Circuit itself.[1]

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[1] The other arguments of the taxpayers stem from a statement in the *Stoddard* opinion as to when income is taxed under the assignment of income rule, a point which the court below did not reach because of its holding that the oil payment assignments constituted sales of property, rather than assignments of income. And see Pet. 13.

With the possibility of disagreement among the judges of the Fifth Circuit in mind and because of the importance of the question presented, the Government filed with the court below a printed suggestion that the instant five cases be argued *seriatim* before the court *en banc*. Opposing counsel in all five cases advised the court that they concurred in that suggestion. However, the cases were set down for oral argument *seriatim* but not before the court *en banc*.

2. Taxpayers attempt to belittle the importance of the question presented by resorting to various arguments, only two of which require comment. The *Wrather* brief (p. 9) asserts that review by this Court is not necessary because the lower courts will not "permit mere form to prevail over substance." But that is exactly, we contend, what the court below did in all five of these cases. The *O'Connor* brief (pp. 12–15), on the assumption that the Government's only argument is that *all* oil payment assignments for a consideration constitute assignments of income, argues that such an "extreme position" (Br. 13) is untenable and that the decisions below furnish criteria for determining whether any given oil payment assignment constitutes an assignment of income as distinguished from the sale of a capital asset. But, as we understand the criteria discussed by the court below, only the most exceptional oil payment assignments for a consideration will be unable to qualify as sales of capital assets. No explanation is given as to how the holdings below can be reconciled with the principles applied in *Slagter*. Moreover, the Government's so-called "extreme position" is not the only possible basis for decision by this Court in enunciating the standards applicable to the taxation of oil payment assignments.[4]

3. In *Fleming*, which differs from the other cases only in that the oil payment assignments were made in return for real estate rather than for cash, the taxpayers contend that their case need not be considered

[4] That position was not argued by the Government on appeal in either the present cases or *Slagter*, but *Slagter* was nevertheless reversed on the basis of the assignment of income rule.

along with the others because it involves a separate preliminary question. However, this question, relating to the holding below that the Flemings' oil payment transactions are not taxable at all under Section 112 (b) (1) (Pet. 22-23), is so intimately related to the ultimate issue in all of the cases that its consideration by the Court is believed to be highly warranted.

If the *Fleming* decision on the preliminary question is allowed to stand, the owners of oil interests can avoid ordinary income tax on oil income by the simple expedient of assigning oil payments for real estate and then selling the real estate at any time after six months, the proceeds being taxed at the favorable capital gain rates. In that respect, the decision below offers a means of circumventing a decision in favor of the Government on the main issue in the cases.

Moreover, the Flemings are in error in asserting (Br. 8) that there is no conflict on this preliminary question. Section 112 (b) (1), so far as pertinent here, provides for the nonrecognition of gain only if "property held for productive use in trade or business * * * is exchanged solely for property of a like kind * * *." Thus, it is required that "property" be "exchanged" by the taxpayer. Under the *Slaytor* decision of the Seventh Circuit, the Flemings' oil payment assignments were assignments of future income, rather than exchanges of property. Although *Slaytor* involved Section 117, rather than Section 112 (b) (1), it is unrealistic to suppose that oil payment rights are "property" under a Code provision providing for tax-free transactions if they are not "property" under a Code provision which only accords preferential

tax treatment. The *Fleming* decision is basically in conflict with *Slaughter*.

The respondents' briefs in opposition have, we believe, failed to answer the Government's contentions (Pet. 9–21) that the questions presented are of substantial importance and that the courts of appeals have reached conflicting decisions on these questions. Accordingly, it is respectfully submitted that the petition for certiorari should be granted.

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No. 108

In the Supreme Court of the United States

OCTOBER TERM, 1957

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

P. G. LAKE, INC.

FRANK SCOFIELD, FORMER COLLECTOR OF INTERNAL REVENUE, PETITIONER

v.

DENNIS M. O'CONNOR, ET AL.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WM. FLEMING, ET AL.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

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JOHN WRATHER, ET AL.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

W. F. WEED, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE PETITIONERS

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE PETITIONERS

OPINIONS BELOW

The opinion of the Tax Court in the *Lake* case (R. 13-14) is reported at 24 T. C. 1016. The opinion of the Court of Appeals (R. 16-27) is reported at 241 F. 2d 71.

The findings of fact and conclusions of law of the District Court in the *O'Connor* case (R. 74-78) are reported at 143 F. Supp. 240. The opinion of the Court of Appeals (R. 80-86) is reported at 241 F. 2d 65.

The findings of fact and opinion of the Tax Court in the *Fleming* case (R. 142-155) are reported at 24 T. C. 818. The opinion of the Court of Appeals (R. 180-189) is reported at 241 F. 2d 78.

The memorandum findings of fact and opinion of the Tax Court in the *Weather* case (R. 211-213) are not officially reported. The opinion of the Court of Appeals (R. 237-238) is reported at 241 F. 2d 84.

The findings of fact and opinion of the Tax Court in the *Weed* case (R. 252-261) are reported at 24 T. C. 1025. The opinion of the Court of Appeals (R. 262-264) is reported at 241 F. 2d 69.

All of the opinions (*supra*) are reproduced in the petition for certiorari at pp. 28-107.

JURISDICTION

The judgments of the Court of Appeals in all five cases were entered on February 1, 1957. (R. 27, 87, 190, 238-239, 265.) The petition for a writ of certiorari was filed April 17, 1957, and was granted June 3, 1957. The jurisdiction of this Court rests upon 28 U. S. C., Section 1254.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 and Treasury Regulations are set forth in the Appendix *infra*, pp. 59-63. They are as follows: Sections 22 (a), 112 (a) and (b) (1), 117 (a) (1) and (4), (b), and (j) (1) and (2) of the 1939 Code and Sections 29.112 (a)-1 and 29.112 (b) (1)-1 of Treasury Regulations 111.

QUESTIONS PRESENTED

In each of the five cases, the taxpayer received a lump sum consideration for assignment of a so-called oil payment right (or sulphur payment right) carved out by the taxpayer from a larger mineral interest producing income taxable as ordinary income (subject to a depletion deduction). The principal question presented is whether the consideration received for the assignment is taxable as ordinary income (subject to a depletion deduction), as the Government contends, or as capital gain under Section 117 of the Internal Revenue Code of 1939, as the court below held.

The *Fleming* case also presents the following preliminary question: whether the exchange of an oil payment right for a fee simple interest in real estate

constitutes a tax-free exchange of property of like kind within the meaning of Section 112 (b) (1) of the 1939 Code.

STATEMENT

The *Lake*, *Fleming*, *Wrather*, and *Weed* cases involve income tax deficiencies and originated in the Tax Court. The *O'Connor* case is a suit for refund of income taxes filed in a district court pursuant to 28 U. S. C., Section 1340. In all five cases, the controversy is with respect to the proper treatment, for income tax purposes, of assignments or exchanges of oil (or sulphur) payment rights.[1]

The trial courts, following the lead of the court below in *Caldwell* v. *Campbell*, 218 F. 2d 567 (C. A. 5th), held that the transactions constitute sales, and in the *Fleming* case exchanges, of a capital asset within the meaning of Section 117 of the Internal Revenue Code of 1939 rather than, as the Government contended, assignments of future income. (R. 13–14, 77–78, 153, 155, 212–213, 258–261.) On this issue, in all five cases, the court below affirmed the decisions of the trial courts (R. 16–27, 80–86, 187, 237–238, 262–264.) In the *Fleming* case, the court also held, disagreeing with the Tax Court on a preliminary issue,

[1] Although the language used in the instrument of transfer may vary, an "oil payment" or "oil payment right" is merely a right to receive a specified sum of money (or barrels of oil) payable out of a stipulated portion of oil or oil proceeds if, as, and when the oil is produced. *Anderson* v. *Helvering*, 310 U. S. 404, 410. The right is free and clear of all costs and expenses of production and in that respect is similar to a royalty interest which is, however, "a right to receive a specified percentage of all oil and gas produced during the term of the lease". *Id.*, p. 409.

that exchanges of oil payment rights for real estate were tax-free under Section 112 (b) (1). (R. 180–187.)

The following is a summary of the basic facts in each case:

Lake case

The facts in this case were all stipulated. (R. 7–12, 14.)

P. G. Lake, Inc. (hereinafter called the taxpayer) is a Delaware corporation with its principal office in Tyler, Texas. It is engaged in the business of producing oil and gas. Its properties included the ⅞ working interest[1] in two commercial oil and gas leases, the Reid and Owens Leases, from which it, as the operator, was producing oil in substantial quantities on December 29, 1950. (R. 7–8.)

On that date, being indebted to its president, P. G. Lake, in the sum of $600,000, taxpayer, in consideration of the cancellation of that indebtedness, assigned an oil payment right (see R. 8–10) to its president in the amount of $600,000 plus an amount equal to interest at 3 percent per annum on the unpaid balance remaining from month to month, payable out of 25 percent of the oil attributable to taxpayer's working interest in the Reid and Owens Leases.[2] On the date

[1] The "working interest" is the name commonly given to the leasehold interest and is the entire mineral interest less the royalty interest, usually ⅛, customarily retained by the lessor. See Breeding and Burton, *Taxation of Oil and Gas Income*, Sec. 2.01 (1954); Welsch, *Tax Aspects of Owning and Disposing of Interests in Oil and Gas*, 38 Taxes, Tax Magazine 855 (1953).

[2] The oil payment assignment took the form of a conveyance of "such an interest" in the oil and gas leases "so that" the

of the assignment, it could have been estimated with reasonable accuracy that the assigned oil payment right would pay out in 3 or more years. The actual pay-out period was from January 1951 to February 1954, slightly more than 3 years. (R. 8–11.)

In its 1950 income tax returns, taxpayer reported the oil payment assignment as a sale of property producing a profit of $600,000 taxable as long-term capital gain under Section 117. The deficiency involved in the case results from the Commissioner's determination that the $600,000 (less $660 representing the cost of documentary stamps) is taxable as ordinary income subject to depletion instead of being entitled to preferential tax treatment as capital gain. (R. 11.)

O'Connor case

The facts are reflected in a stipulation of facts (R. 47–50) and the testimony of two witnesses for the taxpayers (R. 57–72). The District Court's findings of fact are contained in the record at pages 74–77.

Here the so-called sale of an oil payment right, consisting of an oil payment assignment for a consideration, was made by the executors, heirs, and devisees of the estate of Thomas O'Connor for the purpose of raising money to pay federal estate taxes, state in-

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assignee "shall own" 25 percent "of all oil and gas in, under or upon such leases and each of them, and shall be entitled to receive" 25 percent of 7/8ths of all the oil, gas, and other minerals "produced, saved and marketed" from the leases "until" the grantee "shall have received by virtue of this interest the sum of" $600,000 plus 3 percent interest (R. 9), at which time the assigned "interest" was to "revert to and revest" in the grantor (R. 10).

heritance taxes, and administration expenses. (R. 47, 76.) In the fiduciary income tax return filed on behalf of the estate for the fiscal period ended November 30, 1948, the proceeds received for the oil payment assignment were reported as ordinary income subject to depletion, but claims for refund were subsequently filed on the ground that the proceeds should have been reported as capital gain. The claims for refund were denied, and this suit for refund followed. (R. 76-77.)

The oil payment assigned by the estate (Ex. B, R. 38-42) on November 26, 1948, was payable out of the income from eight oil royalty interests which the decedent, who died in 1946, had received in 1931 in executing oil and gas leases on property owned by him. (R. 61-62.) The assignment was made to D. L. Blackburn, the president of a bank whose stock was in part (12%) owned by the O'Connors (R. 69), and was in the amount of $10,000,000 plus an amount equal to 4 percent interest per annum on the unrealized balance thereof remaining from month to month, payable out of the oil proceeds from the estate's eight royalty interests.* For the oil payment assignment, Blackburn paid the estate $9,990,350 ($9,650 less than $10,000,000), which he borrowed from the Chase National Bank in New York on his personal 36-month note, bearing 3½ percent interest, without any security other than a deed of trust on the oil payment right he received from the estate. (R. 48, 68, 70.) Before

*The oil payment assignment (Ex. B, R. 38-42) took the form of conveyances of the royalty interests subject to reversion to the assignors when Blackburn had received the specified total amount of money.

making the loan, the Chase National Bank in New York sent its own engineers down to Texas to value the properties and received their approval of the collateral (the oil payment right). (R. 70-71.)

On the date of the oil payment assignment, it could be estimated from available information that pay-out of the assignment would require about 4,000,000 (or about 17 percent) of the remaining 23,150,000 barrels of oil in place attributable to the royalty interests. The assignment paid out in three years. (R. 49-50.)

Fleming case

The facts were all stipulated. (R. 143, 159-179.) In this case, the oil payment assignments were made for real estate rather than for cash. In their income tax returns, taxpayers treated the transactions as tax free exchanges of property of like kind under Section 112 (b) (1) of the 1939 Code, reporting no income at all from the transactions. (R. 164, 166.) The Commissioner determined deficiencies on the ground that the exchanges were not tax free and that the income therefrom, measured by the fair market value of the property, was taxable as ordinary income subject to depletion. (R. 164-165, 166.) The Tax Court agreed with the Commissioner that the transactions were not exchanges of property of like kind so as to be tax free under Section 112 (b) (1), but held, as contended by the taxpayers, that the income from the transactions was taxable as capital gain rather than as ordinary income subject to depletion. (R. 149-155.) On cross-appeals to the Fifth Circuit,

that court held that the transactions were not taxable at all under Section 112 (b) (1) but that, if such a view is erroneous, the income from the transactions is taxable as capital gain under Section 117 of the 1939 Code. (R. 180-187, 189.)

Two so-called exchanges are involved. The first one (see R. 161-162) was made on May 19, 1948, and consisted of separate oil payment assignments by three related parties—Wm. Fleming individually, a partnership in which he and a trust were the partners (R. 161), and the trust—for undivided fee simple interests in a ranch. Four oil payment assignments (Exs. A, B, C, and D; R. 167-177) were made, one by Fleming individually, one by the partnership, and two by the trust. Three were made by the assignors as "owners of leasehold interests" and the other as owner of a royalty interest. The leasehold and royalty interests involved were held by the assignors for productive use in their respective businesses of produc-

The oil payment assignments by the assignors as leasehold owners each took the form of a conveyance of a mineral interest "carved" out of the grantors' interest. Each was described as a specified interest "in and to all the oil in, under, and that may be produced, saved and marketed" under the leases "until" the grantee "shall have received therefrom oil of the net value of" the specified sum of money plus interest, at which time the conveyed "interest" was to "cease and terminate" and "revert to" the grantor. (Ex. A, R. 168, 169; Ex. B, R. 171, 172; Ex. C, R. 173, 174.) The oil payment assignment made by the trust as the owner of a royalty interest was in similar form, except that it purported to be a conveyance of a terminable "undivided 92.3565 /100ths royalty interest" (Ex. D, R. 175), which was stated to cover "92.3565 /100ths of the 1/8th royalty" on oil to be paid under the terms of a lease (R. 175-176).

ing oil. (R. 162.)[1] As to each assignor, the oil payment assignment or assignments (Exs. A, B, C, and D, R. 167–177) was in an amount which represented the uncontested fair market value of the undivided interest in the ranch received by such assignor (see R. 164–165) plus an amount equal to a specified percentage of interest per annum on the balance thereof remaining unpaid from time to time.

The other so-called exchange (see R. 165–166) was made on October 5, 1949, and consisted of an oil payment assignment by taxpayer F. Howard Walsh, as the owner of oil and gas leasehold interests held by him for productive use in his business of producing oil, for the fee simple title to business real estate in Fort Worth, Texas. This oil payment assignment (Ex. E, R. 177–179), like the others, was in the amount of the uncontested fair market value of the real estate received (see R. 166) plus interest on the

[1] It is stipulated that the interests were held for productive use in the assignors' "respective trades and businesses." It is also stipulated that the partnership business was primarily that of producing oil. (R. 161.) That Fleming individually and the trust were in the business of producing oil is alleged and admitted in the pleadings. (See pars. 5 (b) of petition and answer, R. 91–92, 133; pars. 5 (g) of petition and answer, R. 119, 139.)

unpaid balance thereof remaining unpaid from time to time.

The following tabulation shows the pertinent facts as to each of the oil payment assignments involved in the two so-called exchanges:

By William Fleming individually:

Amount	$73,500 "plus an amount equal to" 5 per cent per annum "on the portions of said $73,500 which may be unsatisfied from time to time" (R. 171)
Consideration received	$73,500 (uncontested fair market value of undivided 25 per cent interest in ranch, R. 165)
Payable out of 40 per cent of assignor's share of oil under leasehold interest. (This is not shown in the oil payment assignment, which merely states that the assignor owned "an undivided interest" in certain leases (Ex. B, R. 170), but the assignment purported to convey a terminable .195668 interest in oil and it was alleged in the complaint (par. 5 (h), R. 92) and admitted in the answer (par. 5 (h), R. 133) that the assignor owned a 41.667 working interest in the leases.)	
Estimated pay-out period (As asserted by taxpayers in the court below, based on the annual amounts received by the assignee as shown in the stipulation of facts)	10 to 12 years for the $73,500 *plus interest*

By the partnership:

Amount	$147,000 "plus an amount equal to" 5 per cent interest per annum "on the portions of said $147,000.00 which may be unsatisfied from time to time" (R. 168)
Consideration received	$147,000 (uncontested fair market value of undivided 50 per cent interest in ranch, R. 165)
Payable out of all but approximately 5½ per cent of the assignor's share of oil under leasehold interest (9/13ths of the oil, payable out of assignor's ⅓ of ⅞, 167, 168).	
Estimated pay-out period	5 years and 8 months for the $147,000 *plus interest*

Wrather case

The basic facts were all stipulated (see R. 207-210, 214-236), although there is some pertinent testimony (see R. 206-207).

By the trust:

(1) Amount	$89,000 "plus an amount equal to" 5 per cent interest per annum "on the portions of said $89,000.00 which may be unsatisfied from time to time" (R. 173)
Payable out of 6/64th of 7/8ths of oil (R. 173) (Extent of assignor's leasehold interest not shown)	
Estimated pay-out period	7 to 8 years for the $89,000 *plus interest*
(2) Amount	$24,500 "plus an amount equal to" 5 per cent interest per annum "on the portions of said $24,500.00 which may be unsatisfied from time to time" (R. 176)
Payable out of 32.3235 1000ths of assignor's 1/8th royalty interest (R. 175-176), or about 8 per cent of assignor's interest.	
Estimated pay-out period	7 to 8 years for the $24,500 *plus interest*
Total amount of the two assignments	$73,500 plus an amount equal to 5 per cent interest
Total consideration received	$73,500 (uncontested fair market value of undivided 25 per cent interest in ranch, R. 165)

By Walsh:

Amount	$65,000 "plus interest at the rate of seven (7) per cent per annum on the balances unpaid from time to time" (R. 179)
Consideration received	$65,000 (uncontested fair market value of real estate, R. 166)
Payable out of 1/4 of 7/8 of oil as to all leases except Killough Lease and out of 1/4 of 7/16 as to Killough Lease (R. 178) (Apparently payable out of 1/4 of assignor's interest, since the assignment states that the assignor owned "all or an undivided interest in the oil and gas leasehold estates" (R. 177).)	
Estimated pay-out period	3 1/2 years

Here, as in the *Lake* and *Fleming* cases, the oil payment assignments were made by a leasehold owner. Taxpayer John Wrather was a member of a partnership which was in the business of both drilling and producing oil (R. 207, 208) and which owned a number of oil and gas leasehold interests, including an undivided 7/24 leasehold, or "working", interest in the Brown Lease on land located in Illinois and an undivided 5/16 leasehold interest on the Kieffer "A" Lease on land located in Indiana (R. 208, 209; Exs. D–4, E–5, F–6, and H–8, R. 214–225, 228–229). Both of these interests were held by the partnership for the development and production of oil and gas. (R. 210.) Both leases were productive and had produced income for the partnership prior to 1948. (R. 208, 209.)

In 1948 the partners, together with their wives, made three so-called sales of oil payment rights to the Indiana Farm Bureau Cooperative Association, Inc. (hereinafter called the Cooperative) with relation to production under the Brown and Kieffer "A" Leases. Even in form, however, the oil payment assignments did not purport to be conveyances of property; they were each made by way of an "Oil Payment Agreement" (see Exs. G–7, I–9, and J–10, R. 225–227, 230–236) under which the partners simply agreed and directed that Cooperative "shall be paid" a stated sum of money "out of the oil produced

and saved", to the extent of a designated portion, until the full specified sum was paid to Cooperative.[5]

In their joint income tax returns for 1948, taxpayers reported taxpayer John Wrather's one-half share of the proceeds received for the oil payment assignments ($143,750) as capital gain. The Commissioner determined that the proceeds are taxable as ordinary income subject to depletion. (See R. 211.)

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[5] The following are the other pertinent facts relating to each oil payment assignment (R. 208-210):

Brown Lease

Date	June 19, 1948
Amount	$130,000
Consideration received	$125,000
Payable out of 9/10 of oil attributable to assignor's leasehold interest (9/10 of 7/24 of 7/8)	
Estimated pay-out period	4 to 6 years
Actual pay-out period	4 years

Kuffel "C" Lease

(1) Date	June 19, 1948
Amount	$155,000
Payable out of 9/10 of oil attributable to assignor's leasehold interest (9/10 of 5/16 of 7/8)	
(2) Date	August 16, 1948
Amount	$12,500
Payable out of 9/10 of oil attributable to assignor's leasehold interest (9/10 of 5/16 of 7/8)	
Total amount of the two assignments	$167,500
Total consideration received	$162,500
Estimated pay-out period for both assignments	4 to 6 years
Actual pay-out period for both assignments	5 years and 5 months from first assignment

Wood case

The facts as found by the Tax Court (R. 253-258), based on testimony and exhibits (unprinted), may be summarized as follows:

Here the so-called sale was of a sulphur, instead of an oil, payment right. The taxpayer was the owner of a pooled overriding royalty interest in sulphur produced by the Texas Gulf Sulphur Company from a tract of land, referred to as Boling Dome, in Wharton County, Texas.[2] The royalty interest entitled taxpayer to receive $0.00966133 per long ton of sulphur produced from Boling Dome by the company, irrespective of what the market price for such sulphur might be. Royalty payments were made by the company monthly, based on the previous month's production. (R. 254.)

In the summer or early fall of 1947, taxpayer and two certified public accountants, Marion Munro who was retained by two of taxpayer's corporations and Frank C. Taylor who was retained as accountant for taxpayer's personal affairs, discussed taxpayer's business commitments and the need for providing some sure source of funds for payment of taxpayer's indi-

[2] The Boling Dome tract was composed of a number of parcels of land. The owners of the royalty interests in sulphur produced from each of those individual parcels entered into a pooling agreement pursuant to which royalties from sulphur produced anywhere in Boling Dome were to be distributed pro rata among all such royalty interest holders. Taxpayer's interest is thus referred to as "pooled". (R. 254.)

vidual income taxes, especially those due in January 1948. It was suggested that taxpayer might sell a portion of his Boling Dome royalty interest, and Munro expressed the opinion that such a transaction would have the advantage of being taxed at capital gain rates. Munro also indicated a probable willingness to purchase a portion of the royalty interest. Due consideration was given to the possible tax savings to taxpayer and to the annual royalty payments which Munro would probably receive. As a result, taxpayer and Munro agreed upon a sulphur payment assignment based upon taxpayer's anticipated requirements for funds to pay taxes for the succeeding three years and upon a four-year pay-out period to Munro from sulphur production. Munro advised taxpayer that the latter's tax saving from the transaction would be about $4,000 to $4,500, and Munro estimated that his own profit from the transaction, allowing for interest payable on a loan necessary to make the purchase, would approach $2,000. (R. 255–256.)

As a result, on December 24, 1947, taxpayer assigned to Munro a sulphur payment (Ex. C, R. 248–250) totaling $50,000 and consisting of 86.254514 percent of his pooled royalty interest (*i. e.*, $0.00833333) per long ton on 6,000,000 long tons of the remaining 21,000,000 long tons of sulphur to be produced from Boling Dome.[10] For the sulphur payment assignment,

[10] The Tax Court found as a fact that the estimated number of tons of sulphur still in place was 45,000,000 tons (R. 255), but that finding was based on testimony of taxpayer which, according to an affidavit he filed in the Court of Appeals, should be interpreted as meaning that 45,000,000 tons was the

Munro gave taxpayer—

Check dated 12/24/47	$13,900
Promissory note due 12/24/48 (with 6% annual interest after maturity)	16,300
Promissory note due 12/24/49 (with 6% annual interest after maturity)	16,300
	$46,500

The purchase money, including payment of the notes shortly before their due dates, was borrowed by Munro from a bank with the sulphur payment assignment as security, except that the amount of royalties Munro received prior to the due dates of the notes made it unnecessary for him to borrow more than $11,500 to pay the notes. The assigned sulphur payment right paid out in 28 months. (R. 256–257.)

The case involves only the taxable years 1948 and 1949, the years in which the note payments were received by taxpayer as part of the proceeds from the sulphur payment assignment. The $16,300 received in each of those years was reported by taxpayer as capital gain, and the Commissioner determined that it was taxable as ordinary income subject to depletion. (R. 257–258.)

SUMMARY OF ARGUMENT

I

The inquiry here is whether each of the assignments in these cases was a "sale" or "exchange" of "property" constituting a "capital asset" within the meaning of Section 117 of the Internal Revenue Code of 1939.

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original estimated tonnage—that the *remaining* tonnage at the time of the assignment was 21,000,000 tons.

A. This Court's decisions have established that Section 117 must be interpreted and applied consistently with the congressional purpose to accord preferential tax treatment only to a capital gain, meaning the gain derived from the conversion (or "realization") of the increase in the value of capital investment property. A so-called sale or exchange does not result in capital gain if it is an assignment of future income—a transaction where the "property" sold or exchanged consists only of a right to receive future ordinary income, and where the conversion is not of the increase in the value of capital investment property, but rather of future ordinary income into present income. In such a case, the proceeds of the sale are to be treated for federal tax purposes as a substitute for, and as having the same character as, the future ordinary income which the transferor would himself have received but for the transfer of the right to receive it.

B. Each of the oil payment assignments in the *Lake, O'Connor, Fleming*, and *Wrather* cases, made by the taxpayers as the owners of leasehold or royalty interests, conveyed to the assignee the right to receive a specified portion of the assignor's future oil proceeds. In *Wood*, where the assignment was of a sulphur rather than of an oil payment right and made by the owner of a pooled sulphur royalty interest, the conveyance was of a right to receive a specified dollar amount on a specified number of tons of the future sulphur production. The oil and sulphur payment assignments were all assignments of future income, rather than sales or exchanges of property within the meaning of Section 117, for several reasons.

1. The proceeds received from the production and sale of oil are taxable as ordinary income subject to a depletion allowance. Taxpayers' income-producing, or capital investment, property consisted of leasehold and royalty interests. Since they assigned oil payment rights, their assignments were not of any portion of their oil interests as such and the assignments were unaccompanied by any assignment of taxpayers' income-producing, or capital investment, property. Under the decisions of this Court, the so-called sales were therefore merely assignments of future income.

It is immaterial that oil payment assignments may be recognized as sales of property for some purposes under local law. For tax purposes, transfers of oil interests are treated according to their effect in relation to economic ownership of the oil in place, and it is the oil in place in which a leasehold or royalty owner is deemed to have his capital investment. Oil payment assignments by leasehold and royalty owners do not convey economic ownership of any portion of the oil in place. Taxpayers' oil payment assignments merely created a contractual right to collect a portion of taxpayers' future oil proceeds and, as such, the oil payment assignments were clearly assignments of future income.

2. Assuming that the oil payment assignments constituted transfers of oil (that is, of a portion of taxpayers' economic ownership thereof), the assignments are still assignments of future income. The decisions of this Court establish not only that the proceeds received from the current production of oil are taxable as ordinary income subject to the depletion allowance

but that, when the transferor creates and retains an economic interest in the oil in place on the execution or so-called sale of a lease, the lump sum consideration (or lease bonus) received by the transferor is an advance payment for oil to be produced and is taxable as ordinary income subject to depletion, just as are the future payments from production under the retained interest. Full recognition is given to the transfer of economic ownership of oil in place but no sale occurs for tax purposes when the transferor retains a different economic interest instead of transferring his entire interest (or a fractional part thereof) as such. The so-called sale is merely of oil, and oil is not a capital asset under Section 117. Similarly, a leasehold or royalty owner who assigns an oil payment retains an economic interest in the oil in place and his assignment, assuming that it transfers ownership to a portion of the oil in place, is of property which is not a capital asset. The consideration received for the oil payment assignment is payment in advance for oil to be produced and, as in the case of a lease bonus, is taxable as ordinary income subject to depletion.

The logic of the lease transfer cases is clear. Oil proceeds, whether received in anticipation of production or as the oil is produced, are subject to a depletion deduction which is designed to compensate for the transferor's loss of capital investment to the extent of the transfer. The oil accordingly represents only ordinary income. The lump sum received for its transfer in anticipation of production is a substitute for and has the same character (that of ordinary income subject to depletion) as the future oil

proceeds which the transferor would have received in the future but for his assignment of the right to collect such proceeds. Necessarily, therefore, oil payment assignments by leasehold and royalty owners are assignments of future income even if they effect a transfer of oil.

3. Finally, taxpayers' oil and sulphur payment assignments were but assignments of future income even when considered without reference to the depletion deduction or to the decisions of this Court involving transfers of oil and gas leases. Assuming that the oil and sulphur payment assignments carried with them an interest of some sort in taxpayers' capital investment property, the assignments must still be viewed in the light of realities and practical considerations, rather than according to the "attenuated subtleties" of property law. They were primarily of future income and, as transfers of taxpayers' capital investment property, too temporary and insubstantial to be treated as sales of property within the meaning of Section 117.

Viewed realistically, taxpayers' oil and sulphur payment assignments resulted only in a conversion of future income into present income, rather than in a conversion of the increase in the value of their capital investment property. Taxpayers are seeking preferential tax treatment for transactions which are merely a means of anticipatorily realizing future ordinary income from property of a type for which a special means of recovering the capital investment therein, the depletion deduction, has been provided and is avail-

able in respect of the consideration received for the transfers made by these taxpayers.

II

For several reasons, the so-called exchanges of oil payment rights for fee simple interests in real estate involved in the *Fleming* case were not tax-free exchanges of property of like kind within the meaning of Section 112 (b) (1). First, the transfers were assignments of future income, rather than exchanges of property. Secondly, they did not transfer "property held for productive use in trade or business", as required by Section 112 (b) (1); and, even if it could be said that they transferred oil, such a transfer would be expressly excluded from the operation of the section as being "property held primarily for sale" by taxpayers. And thirdly, the transfers were not of property "of a like kind" to real estate.

ARGUMENT

I

THE LUMP SUM CONSIDERATION RECEIVED BY TAXPAYERS FOR THEIR OIL (OR SULPHUR) PAYMENT ASSIGNMENTS IS TAXABLE AS ORDINARY INCOME SUBJECT TO DEPLETION, RATHER THAN AS CAPITAL GAIN UNDER 1939 CODE SECTION 117

In all five cases, the taxpayers received cash (or real estate in *Fleming*) as a present consideration for oil payment assignments (or, in *Weed*, for a sulphur payment assignment). The proceeds were received without restriction by taxpayers who report their income on the cash basis and are therefore clearly

taxable in the year or years of receipt (the taxable year or years involved in each case).[11]

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[11] *Healy* v. *Commissioner*, 345 U. S. 278, 281. As to a taxpayer on the cash basis, income received under a claim of right and without restriction as to its disposition is taxable in the year of receipt even though it may be claimed that the taxpayer is not entitled to retain the money and even though, as is not the case here, he may subsequently have to refund its equivalent. See *Healy* v. *Commissioner*, *supra*; *United States* v. *Lewis*, 340 U. S. 590; *North American Oil* v. *Burnet*, 286 U. S. 417. This is what is usually called the "claim of right" doctrine. Cf. *Automobile Club* v. *Commissioner*, 353 U. S. 180, 188–189.

In *Commissioner* v. *Slagter*, 238 F. 2d 901, where the Seventh Circuit, unlike the court below, held that an oil payment assignment for a consideration was an assignment of future income rather than a sale of property within the meaning of Section 117, the court seems to have treated the proceeds of the assignment as a loan to the taxpayers. In any event, the court concluded its opinion with a statement (p. 905) to the effect that the oil payments as such were taxable to the taxpayer-assignors as and when subsequently accumulated and paid to the assignee. That is the rule in respect of donative assignments of income, where the donor's realization of income is economic rather than pecuniary. *Helvering* v. *Horst*, 311 U. S. 112. That rule is "founded on administrative convenience" and "is only one of postponement of the tax to the final event of enjoyment of the income." *Id.*, p. 116. In assuming the applicability in *Slagter* of the rule as to when income is taxed in respect of a donative assignment of income, the Seventh Circuit overlooked the fact that the only question in the case, as argued by both parties there as here, was as to *how* the *proceeds* of the oil payment assignment were to be taxed in the *year of receipt*, the only taxable year before the court. When a lump sum consideration is received for an assignment of income, without any obligation of repayment and without any restriction as to use or disposition, it is impossible to ignore the fact that the recipient realizes income immediately upon receipt of the consideration. And see the text, *infra*, pp. 29–30.

The issue here is whether that income is subject to tax at the rates applicable to ordinary income (subject to an allowance for depletion) or at the lower capital gain rates. The court below concluded that the oil payment transactions constituted sales (and, in *Fleming*, exchanges) of property and, accordingly, held the income entitled to the preferential tax treatment accorded to long-term capital gain by Section 117 of the Internal Revenue Code of 1939 (Appendix, *infra*, pp. 60–62).[12] The Government contends that the transactions are not within the purview of Section 117 and that the proceeds are accordingly taxable as ordinary income (subject to an allowance for depletion).

This contention does not, however, rest upon an argument that the transactions could not possibly be characterized as sales and exchanges of property for some purposes under local law unrelated to the federal income tax. As this Court stated in *Burnet* v. *Harmel*, 287 U. S. 103, 110 (a closely related case involving the application of a predecessor of Section 117 to a lump sum bonus received by a landowner on the execution of an oil and gas lease), "we are concerned only with the meaning and application of a [tax] statute enacted by Congress". Accordingly, the question is whether these oil payment transactions are to be treated as sales or exchanges of property within the meaning of Section 117. See *Commissioner* v. *Slaytor*, 238 F. 2d 901 (C. A. 7).

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[12] Under Section 117, only one-half of the amount of long-term capital gain is taxed. See Sections 117 (a) (4) and (b), Appendix, *infra*, pp. 60–61.

A. ASSIGNMENTS OF FUTURE INCOME FOR A CONSIDERATION, WHETHER OR NOT CHARACTERIZED AS SALES OR EXCHANGES FOR SOME LOCAL LAW PURPOSES, DO NOT COME WITHIN SECTION 117

1. The assignment of income rule generally

The "assignment of income" rule, as applied to the future income from property, is that one who retains the income-producing property (or "tree") and transfers what amounts only to a right to receive future income from that property (the "fruit") remains taxable on that income, because in making the transfer he has derived economic benefit which constitutes a realization of the income. In its basic form, the rule is perhaps best illustrated by *Helvering* v. *Horst*, 311 U. S. 112, where a father, who owned a bond, made a gift of one of the interest coupons to his son and was held taxable on the interest as and when collected by the son.

For present purposes, the importance of the assignment of income rule lies, not in when income is taxed thereunder (for that is not in issue here [13]), but in the nature of the income (*i. e.*, ordinary income or capital gain) received by the assignor. Thus, in the *Horst* case, *supra*, both the bond retained by the father and the interest coupon which he gave to his son constituted "property", but one type (the interest coupon) amounted only to a right to receive future income from the income-producing property (the bond), and therefore the transfer of this right, even though under state law it be regarded as a "property"

[13] See note 11, *supra*.

right, was considered not a transfer of property under Section 117 but an assignment of future income. There, of course, the income "property" was separable from the income-producing (or capital investment) property. But the rule has also been applied where, although there was a transfer of the income-producing (or capital investment) property itself, the transfer was only temporary or insubstantial. (See *infra*, pp. 48–50.)

In short, an "assignment of future income", or "anticipatory assignment of income", is a transfer of something which, although perhaps in some respects treated by local law as "property" or a "property" right, represents essentially only a right to receive future income, when considered from the standpoint of practicalities and in the light of what the transferor had, retained, and assigned. It stands in direct contrast with a transfer of the income-producing property in which the taxpayer has his capital investment—and it is only the latter type of transfer which, when made for a consideration, is entitled to the capital-gain benefits conferred by Section 117.

2. Assignments of future income for a consideration as related to the scope of Section 117

Section 117 applies to the "sale" or "exchange" of "property" falling within the category of "*capital assets*". Not all sales and exchanges of property are sales or exchanges of capital assets. Some are specifically excluded by the definition of "capital assets" contained in Section 117 (a) (1), such as sales of stock in trade and of property held primarily for sale

to customers in the ordinary course of business. In addition, the statute must be interpreted and applied so as to effectuate the manifest purpose of Congress (*Corn Products Co.* v. *Commissioner*, 350 U. S. 46, 52; see also *Burnet* v. *Harmel*, 287 U. S. 103); the statutory language is not to be interpreted literally or according to its usual meaning when to do so would thwart that purpose (*Helvering* v. *Hammel*, 311 U. S. 504, 510–511). Even true sales which "do not come within the literal language of the exclusions set out in that section" (*Corn Products Co.* v. *Commissioner*, *supra*, p. 51) are excluded from its operation when they do not fall within its intended coverage. That is forcefully illustrated by the *Corn Products Co.* case, *supra*, where, under the circumstances involved, sales of corn futures were excluded from Section 117 because they constituted a normal source of business income.

As the Court stated in the *Corn Products Co.* case, *supra*, p. 52, Section 117 "was intended 'to relieve the taxpayer from . . . . excessive tax burdens on gains resulting from a *conversion of capital investments*, and to remove the deterrent effect of those burdens on such conversions.' *Burnet* v. *Harmel*, 287 U. S., at 106." (Italics supplied.) Thus, the sole purpose of Section 117 is to accord preferential tax treatment, by way of relief from otherwise excessive tax burdens, to the gain derived, through a sale or exchange, from an increase in the value of property in which the taxpayer has a capital investment. That

of course is also implicit in the fact that, by its terms, Section 117 applies to *capital* gain derived from sales and exchanges of *capital* assets."[14] See *United States* v. *Snow*, 223 F. 2d 103, 108 (C. A. 9th), certiorari denied, 350 U. S. 831. It necessarily follows, therefore, that Section 117 is inapplicable to an assignment of future income for a consideration, or to a so-called sale of property of a type which for all practical purposes amounts only to a right to receive future income.

An anticipatory assignment of income for a consideration is also not a "sale" or "exchange" within the meaning of Section 117. It operates only as a transfer of future *income* and does not even satisfy the literal requirement of Section 117 that there be a "sale" or "exchange" of property. But, in any event, to be a sale or exchange producing capital gain within the meaning of Section 117, a transfer must effect a conversion of the increase in value of a capital asset into realized gain. No such conversion is effected by an assignment of future income for a con-

[14] Subsection (j), which was added to Section 117 by Section 151 (b) of the Revenue Act of 1942, c. 619, 56 Stat. 798, accords capital gain treatment to "property used in the trade or business", defined, so far as pertinent here, as including "real property used in the trade or business, held for more than 6 months, which is not * * * (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." This subsection was added simultaneously with an amendment which excluded "real property used in the trade or business of the taxpayer" (see Section 151 (a) of the 1942 Act, *supra*) from the definition of "capital assets" contained in Section 117 (a) (1) and represents no change in the purpose of Section 117, at least so far as pertinent here.

sideration. The conversion is, not of any increase in the value of the capital asset, but merely of *future* income into *present* income; the transferor merely obtains the present value of the income which he would otherwise receive in the future." To treat such assignments of income for a consideration as sales or exchanges of property under Section 117 would distort the basic distinction between ordinary income and capital gains, and would result in a tax windfall to taxpayers who would otherwise pay tax at the higher rates paid by all other taxpayers receiving similar income.

Accordingly, in a variety of situations, the Courts of Appeals have held the benefits of Section 117 inapplicable to sales which were in substance only assignments of future income, holding that the consideration received therefor is taxable as ordinary income rather than as capital gain. See *Helvering* v. *Smith*, 90 F. 2d 590 (C. A. 2d) (lump sum received for partner's share of accounts receivable of partnership); *Rhodes' Estate* v. *Commissioner*, 131 F. 2d 50 (C. A. 6th) (sale of dividend declared but not yet payable); *Fisher* v. *Commissioner*, 209 F. 2d 513 (C. A. 6th), certiorari denied, 347 U. S. 1014 (sale, along with notes, of right to collect defaulted interest); *United States* v. *Snow*, 223 F. 2d 103 (C. A. 9th), certiorari denied, 350 U. S. 831 (sale, along with partnership interest, of partner's share of accrued but undistributed earnings of partnership); *Doyle* v. *Commissioner*, 102 F. 2d 86 (C. A. 4th) (settlement sum received by partner, on dissolution of partnership, for his proportionate share of uncollected fees of

partnership); *Halbert* v. *Commissioner*, 227 F. 2d 399 (C. A. 7th) (anticipatory transfer of business income of partnership under agreement for future sale of business). As the Second Circuit long ago stated in *Helvering* v. *Smith*, *supra*, p. 592: "The 'purchase' of that future income did not turn it into capital, any more than the discount of a note received in consideration of personal services. The commuted payment merely replaced the future income with cash." In short, in any case where the lump sum consideration is essentially a substitute for what would otherwise be received in the future as ordinary income, the lump sum consideration is taxable as ordinary income even though, in a sense, a transfer of "property" is involved. See cases just cited and *Watson* v. *Commissioner*, 345 U. S. 544; *Hort* v. *Commissioner*, 313 U. S. 28; *United States* v. *Safety Car Heating Co.*, 297 U. S. 88.

This general principle, the validity of which is beyond dispute, is fully applicable to the facts of these cases, as we shall now demonstrate.

B. TAXPAYERS' OIL (OR SULPHUR) PAYMENT ASSIGNMENTS WERE ASSIGNMENTS OF FUTURE INCOME

The taxpayers in four of these cases were the owners of oil and gas leasehold interests (*Lake*, *Fleming*, and *Wrather*) or of oil royalty interests (*O'Connor* and as to one of the assignments in *Fleming*), both of which are depletable interests (*Burnet* v. *Harmel*, 287 U. S. 103; *Anderson* v. *Helvering*, 310 U. S. 404.

408).[15] Those taxpayers each carved out of their larger interests lesser interests called oil payment rights—the right to receive a specified portion of the assignor's future oil proceeds from a stipulated portion of the oil if, as, and when produced (*id.*, p. 410)—and assigned such lesser interests for a consideration. In the *Weed* case, the taxpayer was the owner of a sulphur royalty interest, which is also a depletable interest (see Sections 23 (m) and 114 (b) (4) (iv) of the 1939 Code, 26 U. S. C. 1952 ed., Secs. 23 and 114), and he assigned a sulphur payment right, consisting of the right to receive a stated

[15] The owners of a leasehold interest, which is the "working interest", have control over oil production and liability for all the costs and expenses of operation and production (Breeding and Burton, *Taxation of Oil and Gas Income* (1954), Sec. 2.04) and are the owners of the entire mineral interest less the royalty interest customarily retained by the landowner-lessor or sublessor (*id.*, Secs. 1.07, 2.04, and 3.02; Welsch, *Tax Aspects of Owning and Disposing of Interests in Oil and Gas*, 31 Taxes, Tax Magazine 855 (1953); *Burnet* v. *Harmel*, 287 U. S. 103, 106). The owner of a royalty interest (in the *O'Connor* case, royalty interests which had been retained by a landowner-lessor, see R. 61–62) has "a right to receive a specified percentage of all oil and gas produced during the term of the lease" (*Anderson* v. *Helvering*, 310 U. S. 404, 409), which of course is free and clear of the expenses of operation and production for which the leasehold owners are liable. While the owners of royalty interests do not have the same element of control over oil production as the owners of leasehold interests, they are for all practical purposes the owners of a percentage of all the oil and gas in place.

amount of money per ton on a stated portion of the future sulphur production.[16]

We have already shown (*supra,* pp. 25–30) that assignments of future income for a consideration are excluded from the preferential tax treatment accorded to capital gains by Section 117 for the reason that only transfers for a consideration of the transferor's capital investment property are within the purview of that section. The remaining question is whether, under the circumstances here, taxpayers' oil (or sulphur) payment assignments were assignments of future income. It is submitted that they clearly were. First, they conferred on the assignee only a contractual right to collect future ordinary income which, but for the assignments, would have been collected by the taxpayers. Second, at most, the only thing conveyed was oil, which is not a capital asset under Section 117. Third, the transfers were not sufficiently substantial, in relation to taxpayers' retained oil interests from which the oil payments were carved out, to be treated as sales of the taxpayers' capital investment property.

For brevity, our argument will refer to transfers of oil interests, but the reasoning applies equally to the sulphur payment assignment involved in the *Weed* case, which is separately referred to later (*infra,* fn. 21, pp. 41–42).

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[16] The Commissioner allowed a 23 per cent depletion deduction on the consideration received for the *Weed* sulphur payment assignment. (See R. 245.)

1. Taxpayers' assignments conferred only a contractual right to collect future income of the taxpayers

There are three possible types of "property" which might be conveyed by an oil payment assignment carved out of a retained interest: (1) an undivided portion of the transferor's oil interest as such; (2) oil; or (3) a mere contractual right to receive a specified amount of the proceeds of future oil production. Obviously, taxpayers' oil payment assignments did not convey (1) an undivided portion of the taxpayers' oil interests as such. Taxpayers were the owners of leasehold and royalty interests and they conveyed only oil payment rights. It is therefore clear that a different type of property was transferred—*i. e.*, either (2) oil or (3) a mere contractual right to receive a specified amount of the proceeds of future oil production.

In either event, we contend, there was no sale of a capital asset for the purposes of Section 117. In this section of the brief, we shall show that an oil payment assignment carved out of a larger interest (such as a leasehold or royalty interest) does not convey oil; it merely confers on the assignee a contractual right to receive future proceeds from the sale of oil.

(*a.*) Taxpayers' "tree," their income-producing or investment property, consisted of their leasehold and royalty interests. The oil production business "is said to resemble a manufacturing business carried on by the use of the soil" (*Anderson* v. *Helvering*, 310 U. S. 404, 407–408) "to which the passing of title of the minerals is but an incident" (*Burnet* v. *Harmel*, 287 U. S. 103, 107). The proceeds received by taxpayers from the production and sale of oil are all taxable to

them as ordinary income (*Burnet* v. *Harmel*, *supra*) except for the amount of their depletion deduction, which represents a tax-free return of their capital investment in the leases (see *Anderson* v. *Helvering*, *supra*, p. 408).

Taxpayers' oil payment assignments, unaccompanied by any assignment of the income producing, or capital investment, property which would produce the income, were anticipatory assignments of income of the most fundamental sort, no different from any other assignment of the future income without a proportionate transfer of ownership of the income-producing property. The consideration taxpayers received for their oil payment assignments was a substitute for the future income they would otherwise have received and accordingly has the same character, *i. e.*, ordinary income (subject to depletion).

The very nature of each transaction involved here precludes any other conclusion. Indeed, the parties themselves quite clearly treated the assignments as conveying only a right to future cash payments rather than an investment in oil.

In the *Lake* case, the taxpayer-corporation owed its president $600,000 and, in consideration of the cancellation of the indebtedness, made an oil payment assignment to him in the amount of $600,000 plus an amount equal to 3 per cent interest per annum on the unpaid balance of the $600,000 remaining from month to month. (See Statement, *supra*, p. 5.) Plainly, the oil payment assignment, although it had a relation to unproduced oil, amounted only to payment of an indebtedness, plus interest thereon, with a "property" right which had a market value

and was transferable but which, from a practical standpoint, represented only an anticipatory assignment of a portion of the debtor's future, assured cash income.

In the *O'Connor* case (see Statement, *supra*, pp. 7–8), a sale resulted only because the assignors used an intermediary to obtain $9,990,350 on a loan from the Chase National Bank in New York with the assigned oil payment right as the sole security. There was no real sale of oil or of an oil interest at a discount price, for the purchaser paid only $9,650 less than $10,000,000 for an oil payment right which paid out in three years and was in the amount of $10,000,000 plus 4 per cent interest thereon, 3½ per cent of which the purchaser in turn paid on the loan of the purchase price from the Chase National Bank in New York. The purchaser made a profit of $110,000 (R. 69), as he had expected (R. 70), on a $10,000,000 transaction which cost him nothing but by virtue of which the assignors seek a refund of over $3,000,000 in taxes.

In the *Fleming* case (see Statement, *supra*, pp. 9–11), the oil payment assignments were each in the exact amount of the fair market value of the real estate received by the assignor plus, in each instance, an amount equal to interest of a stated percentage on the unpaid balance remaining unpaid from time to time. Here, the taxpayers simply used portions of their future oil proceeds to purchase real estate, paying interest on the unpaid portion of the purchase price. The transactions were, in substance,

no different from the execution of a secured promissory note in the amount of the purchase price.

In the *Wrather* case, where three oil payment assignments were made at a flat discount, the oil payment assignments did not even purport to convey anything other than the right to receive *cash* from oil produced. Similarly, in the *Weed* case, it was the right to receive cash which was assigned. (See Statement, *supra*, pp. 13–14, 16.)

Furthermore, any doubt as to the true nature of these transactions should be resolved against the taxpayers. As already pointed out (*supra*, p. 27), this Court has held that the capital-gains provisions are to be "narrowly applied" so as to effectuate the congressional policy of taxing at ordinary income rates the profits "arising from the everyday operation of a business" while, at the same time, limiting preferential capital-gain treatment "to transactions in property which are not the normal source of business income." *Corn Products Co.* v. *Commissioner*, 350 U. S. 46, 52. And, as the *Corn Products* case demonstrates, a transaction may fit the literal language of the statute and yet not qualify for capital-gain treatment where it does not fall within the obvious purpose of Congress and where a taxpayer would otherwise be able (pp. 53–54) "to transmute ordinary income into capital gain at will." This rationale is even more clearly applicable here, where the "capital" or property transferred consists only of a right to receive future income—income which, if the right to receive it were not thus transferred, would undisputably be taxed as ordinary income. In this crucial respect, the instant cases are

indistinguishable from *Horst* and the other cases discussed in Point A, *supra,* applying the basic assignment-of-future-income rule.

(*b.*) The same conclusion—that is, that taxpayers' oil payment assignments were merely assignments of future income—is reached if the problem is approached in terms of ownership of an "economic interest" in the oil in place, for it is only the transfer of such an interest which will be given effect for tax purposes.

For example, on the execution or so-called sale of a lease, the proper tax treatment to be accorded to a lump sum consideration (as well as the transferor's right to depletion) depends upon whether the transferor has retained an economic interest in the oil in place. See, *e. g., Burnet* v. *Harmel, supra; Thomas* v. *Perkins,* 301 U. S. 655; *Anderson* v. *Helvering,* 310 U. S. 404; *Kirby Petroleum Co.* v. *Commissioner,* 326 U. S. 599; *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U. S. 25. An economic interest in the oil in place may also be acquired as well as retained. *Commissioner* v. *Southwest Expl. Co.,* 350 U. S. 308. Here, however, taxpayers' assignments did not result in the receipt by the assignees of an economic interest,[17] and hence the assignments necessarily did no more than confer contractual rights to receive portions of taxpayers' future income.

[17] It should be noted that, even if the assignments did convey an economic interest in the oil in place, the assignees would be entitled to depletion only on the excess of the oil payments over the amount paid for the assignments.

An "economic interest" in the oil in place is synonymous with a capital investment or a depletable interest (*Burton-Sutton Oil Co.* v. *Commissioner, supra,* p. 32). It encompasses two "interrelated concepts" or "factors"—(1) the acquisition, by investment, of an interest in the oil in place, and (2) a legal relationship which makes the receipt of income from that interest dependent solely upon production. *Commissioner* v. *Southwest Expl. Co., supra,* pp. 313–314. In other words, an "economic interest" means a possibility of profit dependent solely upon the extraction and sale of oil in which the taxpayer has a capital investment. *Kirby Petroleum Co.* v. *Commissioner,* 326 U. S. 599, 603, 604.

The assignment by a leasehold or royalty owner of an oil payment carved out of his retained interest fulfills one of the requirements of an economic (or depletable) interest, since it creates a legal relationship pursuant to which the receipt of income by the assignee is dependent solely upon the production of oil. But, as the Court specifically held in *Commissioner* v. *Southwest Expl. Co., supra,* there must also be a capital investment in the oil in place.[18] The cap-

[18] Even before the *Southwest Expl. Co.* decision, the Court had repeatedly emphasized the necessity of a capital investment in the oil in place. See *Palmer* v. *Bender,* 287 U. S. 551, 557–559; *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299; *Thomas* v. *Perkins,* 301 U. S. 655, 661; *Helvering* v. *Bankline Oil Co.,* 303 U. S. 362, 367, 368; *Helvering* v. *O'Donnell,* 303 U. S. 370, 371; *Helvering* v. *Elbe Oil Land Co.,* 303 U. S. 372, 375–376; *Anderson* v. *Helvering,* 310 U. S. 404, 407–411; *Kirby Petroleum Co.* v. *Commissioner,* 326 U. S. 599, 603; *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U. S. 25, 32–33.

ital investment must be in the property to be depleted, the oil in place, because the depletion deduction is "based on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit." *Id.*, p. 312. A mere economic advantage from the production of oil is not sufficient. *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362; Treasury Regulations 111, Section 29.23 (m)-1.

Thus, unless the lump sums paid by each of the assignees of taxpayers' oil payment assignments constituted capital investments in the oil in place, the assignees did not acquire economic (or depletable) interests. It is submitted that no such capital investments were made by the assignees here and, accordingly, that taxpayers' oil payment assignments conveyed to the assignees only contractual rights to collect a portion of the assignors' future oil proceeds, instead of conveying portions of taxpayers' economic interests or capital investment properties.[19]

In the lease transfer cases, where the transferor was held to have retained a depletable economic interest, it was because he retained an interest in which he had a capital investment by reason of the fact that the interest related back to a fee or leasehold interest which included the right to exploit the oil property.[20]

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[19] A distinction might be made in an instance where the consideration for an oil payment assignment is, pursuant to contract, required to be used for further development of the property. Such a distinction is immaterial in these cases since no such agreements were entered into nor was the consideration so used. All taxpayers had unlimited use of the sums received for the assignments.

[20] See *Commissioner* v. *Southwest Expl. Co.*, *supra*, pp. 314–315; *Palmer* v. *Bender*, 287 U. S. 551, 558; *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U. S. 25, 33–35.

But the purchaser of a carved out oil payment right does not make a capital investment in the oil in place unless he makes an "indispensable contribution" to oil production (*Commissioner* v. *Southwest Expl. Co., supra,* p. 317). There was no dedication to production of the proceeds from the oil payment assignments in any of these cases or any other contribution to production by the purchasers. Indeed, in each instance here, the parties themselves treated the proceeds from the oil payment assignments as cash rather than as investments in the oil in place. (See *supra,* pp. 34–36.) Here the capital investment by the purchasers was merely in a right to collect, as nominees of the transferors, a stated amount of the taxpayers' future income from the production of oil in which taxpayers continued to have a depletable economic interest. While it is true that the assignee's right is eventually exhausted, that is so because his rights stem from a contract which contains its own dollar limitations and his rights come to an end when the requisite amount of money has been paid. As the Court recognized in *Anderson* v. *Helvering,* 310 U. S. 404, 410: "The value of the right, * * * is fixed at the moment of creation and does not vary directly with the severance of the mineral from the soil. In this sense it resembles the right to cash payments more closely than the right to royalty payments."

Thomas v. *Perkins,* 301 U. S. 655, in which an oil payment right was held to constitute an economic interest, is inapposite here. In that case the oil payment right was *retained* on the assignment of a lease. It was held to constitute an economic interest on the

theory that, as the Court stated in *Anderson* v. *Helvering, supra,* p. 411, "* * *" the provision in the lease for payments solely out of oil production should be regarded as a reservation from the granting clause of an amount of oil sufficient to make the agreed payments, * * *." Thus, *Thomas* v. *Perkins, supra,* is simply an instance where the requisite capital investment in the oil in place was deemed to carry over from exploitation rights under a chain of title stemming from a leasehold interest.

Since taxpayers' oil payment assignments did not convey an economic interest in the oil in place, they necessarily did not constitute transfers of a portion of taxpayers' capital investment property and conferred upon the assignees only a right to collect portions of the taxpayers' future oil proceeds.[21] The five cases vividly portray, we submit, the lack of merit in the holding below that taxpayers' oil payment assignments are to be treated as sales of capital investment property entitled to preferential capital gain treatment under Section 117. Such preferential tax treatment is reserved for gain attributable to the increase in the value of investment property, whereas (as will now be shown in greater detail) so-called sales of oil payment rights by the owners of leasehold and royalty interests are merely a means of anticipatorily realizing future ordinary income from property of a type for which a special means of recovering the capital investment therein, the depletion deduction, has been specifically provided by Congress.

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[21] The above arguments (pp. 33–41) have equal application to the sulphur payment assignment involved in the *Weed* case. Indeed, the law with respect to oil and gas leases evolved from de-

2. At most, the assignments conveyed oil (or sulphur), which is not a capital asset

We have shown (*supra*, pp. 33–41) that taxpayers' assignments conferred only a contractual right to collect future income and did not convey an economic interest in oil. On that basis alone, we believe a reversal of the decisions below is required. In this part of our brief, we shall assume *arguendo* that taxpayers' assignments did convey an interest in oil. Under that approach also, taxpayers' assignments were assignments of future income rather than sales of property within the scope of Section 117.

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cisions of the Court relating to mining leases. See *Burnet* v. *Harmel*, 287 U. S. 103, 107–108; *Palmer* v. *Bender*, 287 U. S. 551, 557; *Anderson* v. *Helvering*, 310 U. S. 404, 407–408. The proceeds of mining, like the proceeds of oil production, are ordinary income, not capital gain from the conversion of the mineral in place. See explanation in *Burnet* v. *Harmel*, *supra*, pp. 107–108. The depletion deduction is similarly allowable as to sulphur mining. See Sections 23 (m) and 114 (b) (4) (iv) of the 1939 Code. Hence, transfers of sulphur interests, like transfers of oil interests, are to be considered from the standpoint of their relation to an income-producing business, rather than as transfers of property. As a matter of fact, the *Weed* sulphur payment assignment did not even purport to convey any property other than the "property" right to receive a specified dollar amount per long ton ($0.00833333) on 6,000,000 of the remaining 21,000,000 long tons of sulphur to be produced from a particular tract by a particular company. (*Statement*, *supra*, p. 16.)

The only major difference between the *Weed* case and the other cases is that the consideration received for the sulphur payment assignment was not all received in the year the sulphur payment assignment was made. The income involved is that received in two subsequent taxable years in payment of unsecured, non-interest bearing notes. (See *Statement*, *supra*, pp. 16–17.) Being on a cash basis, Weed realized income from the sulphur payment assignment only when he received the consideration therefor in money or in notes which, like money, were freely and easily ne-

In *Burnet* v. *Harmel*, 287 U. S. 103, it was decided that oil is *not* a capital asset. That case involved the execution of an oil and gas lease by a landowner for a lump sum consideration (usually called a lease bonus) plus retained royalties from future production. The Court held that, even though the lease under the applicable state law conveyed title to the oil in place, there was not a sale of property for tax purposes. That case clearly stands for the proposition that the consideration received for an assignment of oil is taxable as ordinary income subject to a depletion deduction, and not as capital gain under Section 117. As the Court there stated (p. 107) and later reiterated in *Anderson* v. *Helvering*, 310 U. S. 404, 407–408, oil production is treated as an income-production operation akin to a manufacturing business, rather than as a conversion of a capital asset consisting of oil in place.

The *Harmel* decision also established the principle that, when the transferor creates a type of interest in the production of oil which is different from that retained, a lump sum consideration received on the

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gotiable. *Bedell* v. *Commissioner*, 30 F. 2d 622, 624 (C. A. 2d); *Nitterhouse* v. *Commissioner*, 207 F. 2d 618, 620 (C. A. 3d); *Ennis* v. *Commissioner*, 17 T. C. 465, 470. The notes he received in 1947 were term notes, one for a year and one for two years, which were not secured and which were non-interest bearing until after maturity. They represented only a plain, unsecured promise to pay in the future and quite obviously were not the equivalent of cash. *Bedell* v. *Commissioner*, *supra*; *Nitterhouse* v. *Commissioner*, *supra*; *Humphrey* v. *Commissioner*, 32 B. T. A. 280; cf. *Perry* v. *Commissioner*, 152 F. 2d 183 (C. A. 8th); *Johnston* v. *Commissioner*, 14 T. C. 560. Accordingly, the consideration which the notes represented was realized and received by taxpayer in 1948 and 1949 when the notes were paid.

execution of a lease is taxable as ordinary income (subject to depletion) just as are the future oil proceeds, and not as capital gain. Thus, in *Harmel*, where the consideration for the execution of the lease consisted of cash and a royalty interest created and retained from the lessor's interest, it was held that there was not a sale for tax purposes and accordingly the cash consideration (or lease bonus) received by the transferor was treated in the same manner as the royalties to be received from future production under the retained royalty interest—that is, as ordinary income (subject to depletion) and not as capital gain.

The principles of *Harmel* were subsequently applied to the so-called sale of a lease (usually denominated as a sublease) (*Palmer* v. *Bender*, 287 U. S. 551; *Helvering* v. *Twin Bell Syndicate*, 293 U. S. 312; *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U. S. 25). Moreover, the Court later expressly held (*Kirby Petroleum Co.* v. *Commissioner*, 326 U. S. 599, 603; *Thomas* v. *Perkins*, 301 U. S. 655; *Anderson* v. *Helvering*, *supra*, pp. 409–410) that the lump sum cash consideration is "payment *in advance* for oil and gas to be extracted" (italics supplied) (*Herring* v. *Commissioner*, 293 U. S. 322, 324). In brief, the mere fact that the execution or so-called sale of an oil and gas lease may result in a division in ownership of the oil does not mean that, for tax purposes, the transfer of oil for a consideration (determined according to economic rather than legal ownership; see *supra*, pp. 37–38) constitutes the sale of a capital asset.

The basic principle of the *Harmel* decision is that oil proceeds, whether received in anticipation or as a result of production, are taxable as ordinary income subject to depletion rather than as capital gain. That principle has been recognized and applied in numerous decisions involving other questions relating to the transfer of oil and gas leases. Although recognition is given to the transfer of economic ownership of at least a part of the oil, the creation and retention by the transferor of an oil interest of a type different from that transferred (such as a royalty interest) has been held to preclude a sale for tax purposes and to entitle the transferor to depletion (allowable only on oil proceeds as ordinary income) not just on the future proceeds received under the retained interest but also on the lump sum cash consideration (or lease bonus) (*Palmer* v. *Bender, supra; Kirby Petroleum Co.* v. *Commissioner,* 326 U. S. 599). Similarly, whether the transferee is taxable on the future payments to the transferor as constituting income to the transferee paid by him to the transferor as purchase price depends upon whether the transferor has retained an interest in oil production (as represented by a royalty or other economic interest). *Anderson* v. *Helvering,* 310 U. S. 404, 407; *Thomas* v. *Perkins,* 301 U. S. 655; *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U. S. 25.

Thus, all of the lease transfer cases demonstrate that a mere transfer of oil, as distinguished from a transfer of the transferor's entire interest as such (or a fractional undivided portion thereof), is not a sale for tax purposes. The oil is not a capital asset and the proceeds

received from the sale of oil, in anticipation of production or as produced, are merely a substitute for the proceeds from future production which are taxable as ordinary income subject to depletion.

It therefore follows that the assignment of an oil payment right carved out by the owner of a leasehold or royalty interest, as in the present cases, does not constitute a "sale" of "property" for the purposes of Section 117. Such an assignment cannot possibly transfer any "property" other than oil (or a mere contractual right to the proceeds of future production, see *supra*, pp. 37–41). While the ownership of oil is one of the attributes of a leasehold or royalty interest, a transfer of a part of the oil by way of an oil payment right carved out of a leasehold or royalty interest can no more be treated for tax purposes as the sale of a capital asset than can a transfer of oil under a lease by a leasehold owner who retains some other interest in production, such as a royalty interest.

The reason for the rule of the lease transfer cases, particularly as applied to oil payment assignments by leasehold and royalty owners, is abundantly clear. The capital investment of the owner of a leasehold or royalty interest is deemed to be in the oil in place. *Palmer* v. *Bender*, 287 U. S. 551, 558; *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U. S. 25, 32; *Commissioner* v. *Southwest Expl. Co.*, 350 U. S. 308. A depletion deduction of at least 27½ percent of the

"gross income from the property"[22] (See Sections 23 (m) and 114 (b) (3) (26 U. S. C. 1952 ed., Secs. 23 and 114)), meaning "income from the oil and gas wells on the property" (*Burton-Sutton Oil Co.* v. *Commissioner, supra,* p. 29, fn. 4), has been provided by Congress "to permit a recoupment of the owner's capital investment in the minerals" (*Commissioner* v. *Southwest Expl. Co., supra,* p. 312). See also *Helvering* v. *Bankline Oil Co.,* 303 U. S. 362, 366. The result is that the depletion allowance "is appropriated by the statute to the restoration of the taxpayer's capital and the rest of the proceeds of the natural asset becomes gross income" (*Kirby Petroleum Co.* v. *Commissioner,* 326 U. S. 599, 603). Thus, the lump sum consideration received for an oil payment assignment by the owner of a leasehold or royalty interest represents anticipatory oil proceeds and is for that reason depletable (as in the case of a lease bonus, see *Herring* v. *Commissioner,* 293 U. S. 322; *Douglas* v. *Commissioner,* 322 U. S. 275); and the depletion deduction compensates the transferor for his loss of capital investment to the extent of the transfer. The transfer is of property which wholly represents income, and the oil payment assignment amounts to nothing more than an assign-

[22] Limited to 50 percent of the net income from the property but not limited merely to recoupment of the amount of the capital investment in the property. See *Commissioner* v. *Southwest Expl. Co., supra,* p. 312, fn. 6.

ment of income.[23] Cf. *Commissioner* v. *First State Bank of Stratford*, 168 F. 2d 1004 (C. A. 5th), certiorari denied, 335 U. S. 867; *Richards' Estate* v. *Commissioner*, 150 F. 2d 837 (C. A. 2d); *Doyle* v. *Commissioner*, 147 F. 2d 769 (C. A. 4th).

3. Even if taxpayers' oil (or sulphur) payment assignments could be considered as transferring some portion of their capital investment property, the insubstantiality of the transfers requires that they be treated for federal tax purposes as assignments of future income

As already indicated (*supra*, p. 26), a determination of whether a transfer of property constitutes an assignment of future income, as distinguished from a transfer of the transferor's capital investment prop-

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[23] That the depletion deduction usually covers *more* than a recoupment of the capital investment is shown by the present record. In the *Fleming* case, under the Commissioner's contention that the consideration received for the oil payment assignments is taxable as ordinary income subject to depletion, Wm. Fleming individually receives a depletion deduction of $20,212.50 for an oil payment assignment which had no cost basis (R. 97); taxpayer Walsh similarly receives a depletion deduction of $17,875 for an oil payment assignment which had no cost basis (R. 112, 466); the partnership receives a depletion deduction of $40,425 for an oil payment assignment which had a basis of $1,102.70 (R. 118); and the trust receives a depletion deduction of $20,212.50 for two oil payment assignments which had a basis of $18,119.21 (R. 120). In the *O'Connor* case, where the taxpayers first reported the consideration received for their oil payment assignment as ordinary income and then sued for refund on the ground that the consideration is taxable as capital gain, the depletion deduction is $2,747,346.25 as against a basis of $1,949,183.55 if the consideration is taxed as capital gain. (R. 35, 48.) Although they received almost $1,000,000 more than the basis of the oil payment assignment, the O'Connors are seeking a tax refund of over $3,500,000 plus interest. (R. 33.)

erty, must be made in the light of "practical considerations." *Harrison* v. *Schaffner*, 312 U. S. 579, 582. The anticipatory assignment of income rule is applicable despite a transfer of title to the income-producing (or capital investment) property if, under the facts and circumstances of the transfer, the transferor remains the *real* owner of the income-producing (or capital investment) property.

That principle was first enunciated in *Helvering* v. *Clifford*, 309 U. S. 331, where the grantor of a 5-year trust was held taxable on the trust income paid to his beneficiary-wife because the dilution of his control over the corpus was not substantial. The principle was subsequently applied to the transfer by a trust beneficiary of a portion of his trust interest (*Harrison* v. *Schaffner, supra*), to the creation of long-term trusts (*Helvering* v. *Stuart*, 317 U. S. 154), to the transfer of patents (*Commissioner* v. *Sunnen*, 333 U. S. 591, and to so-called family partnerships (*Commissioner* v. *Culbertson*, 337 U. S. 733). Even when a transfer is both an assignment of a right to receive future income and a transfer of a proportionate part of the income-producing (or capital investment) property, the nature of the transaction is still controlled by realities rather than by the "attenuated subtleties" of the law of property. *Harrison* v. *Schaffner, supra*, p. 581. As the court below (in considering the effect of an oil payment assignment by the owner of a larger oil payment right) itself stated in *Commissioner* v. *Hawn*, 231 F. 2d 340, 346: "Where the legal effect to be given for tax purposes to what appears in form to be a transfer of an interest in

property is raised, we have the clear teaching of the cases already cited that we must determine whether such transfer is for a substantial interest in the total property owned by the transferor." In making that determination, all of the circumstances are to be considered. *Helvering* v. *Clifford*, 309 U. S. 331; cf. *Commissioner* v. *Sunnen*, 333 U. S. 591.

This so-called "insubstantial transfer" rule was established in decisions involving family gifts, but it is equally applicable to so-called sales to strangers for reasons already indicated (*supra*, pp. 27–29). Under Section 117, the basic inquiry is whether the income derived from a transfer is gain realized on the increase in the value of property. When the transfer for a consideration is of property which is at least primarily an assignment of future income, it is of no consequence that the transfer carries with it some incidental interest in the income-producing (or capital investment) property. The consideration is paid for the right to receive future income, not for an increase in the value of the income-producing (or capital investment) property, unless the transfer is of so much of the transferor's interest that the effect is to shift ownership as related to the entire interest.

For the purposes of applying the insubstantial transfer rule in the present cases to transfers by leasehold and royalty owners, we will assume, contrary to what we have already shown, that taxpayers' oil (or sulphur) payment assignments each carried with them a proportionate part of the assignor's capital investment (or income-producing) property and that the consideration received for the assign-

ments is not depletable. Even on the basis of an assumption so extremely favorable to taxpayers, the assignments are still assignments of future income for a consideration, rather than sales of property within the meaning of Section 117.

We are here dealing with assignments of *assured* future income. Taxpayers' oil and sulphur payment assignments were all made with reference to producing properties. Reasonably accurate estimates of the oil reserves to be produced from those properties, and thus of the oil attributable to taxpayers' leasehold and royalty interests, could be made by modern scientific methods. 32 Taxes, Tax Magazine 494, 500 (1954). The Texas Railroad Commission sets "state oil production quotas" translated "into a specific amount for each field and for each well". *Burford* v. *Sun Oil Co.*, 319 U. S. 315, 320. Thus, at least the approximate rate of production could be forecast and, making allowances for the possible variation in the price of oil, even the approximate time the assigned oil payment rights would pay out could be determined. It is accordingly conceded in four of the cases that the assignments could be expected to pay out within a given time.[24] In the *O'Connor* case, it is a stipulated

[24] The oil payment assignments in the *Wrather* case related to properties in Illinois and Indiana, rather than in Texas, but the approximate pay-out period of those oil payment rights could also be determined.

The estimated pay-out time is stipulated in the *Lake* and *Wrather* cases. (R. 11, 210.) The testimony and Tax Court's findings show the estimated pay-out period in the *Weed* case. (See R. 255.) In the *Fleming* case, the taxpayers have conceded that the estimated pay-out periods could be determined.

fact that both the assignors and the assignee had information available to them which gave them reason to believe that the assignors' royalty interests would produce sums "substantially in excess" of the amount of the assigned oil payment right. (R. 49–50.) In fact, the pay-out of the assigned oil payment right, in the amount of $10,000,000 plus 4 per cent interest, was so assured that the purchaser obtained a $9,990,350 purchase money loan without any security other than a deed of trust on the assigned oil payment right. (R. 48, 68, 70.)

The assignments did not transfer any of the control over production which the taxpayers (with the probable exception of Weed) had under their leasehold and royalty interests.[20] The assignments were temporary transfers at best and did not transfer any substantial portion of the taxpayers' minerals. In the *O'Connor* case, the assigned oil payment right,

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[20] The taxpayers who were leasehold owners (*Lake*, *Fleming*, and *Wrather*) had complete control over production consistently with the terms of the leases involved. See fn. 15, *supra*, p. 31. The taxpayers in *O'Connor* were the owners of a royalty interest which had been retained on the execution of an oil and gas lease (R. 61–62) and accordingly had control over production to the extent that they could enforce the obligations of the lease. The O'Connors' oil payment assignment specifically provided (R. 41) that—

> It is expressly agreed * * * that except as to the right to receive the royalties herein conveyed grantors reserve and retain all the rights, powers and privileges, express or implied, now owned and possessed by them as lessors in such leases.

In all probability, the one royalty interest from which an oil payment right was carved in *Fleming* was also a retained royalty interest.

in the amount of $10,000,000 plus 4 per cent interest, was payable out of about 17 per cent of the assignors' total royalty oil and paid out in 3 years. (Statement, *supra*, pp. 7–8.) In the *Wood* case, the assigned sulphur payment right, in the amount of $0.00833333 per long ton on 6,000,000 of the 21,000,000 remaining long tons or a total of $50,000, was payable out of 25 per cent of the assignor's pooled royalty interest, was expected to pay out in 4 years, and actually paid out in 28 months. (Statement, *supra*, pp. 16–17.) In the other three cases, the estimates of total oil reserves are not shown in the record so as to afford a basis for comparing the amount of assigned oil with the taxpayers' total oil, but it is reasonable to assume that the known reserves were such that they would be nowhere near exhausted until long after the pay-out periods of the assigned oil payment rights. In addition, the assigned oil payment rights were currently payable out of only fractions of the assignors' leasehold oil (and in one instance in *Fleming*, out of royalty oil). In the *Lake* case, the assigned oil payment right, in the amount of $600,000 plus 3 per cent interest, was currently payable out of only 25 per cent of the assignor's leasehold oil and was estimated to and actually did pay out in a little over 3 years. (Statement, *supra*, pp. 5–6.) The several oil payment assignments in the *Fleming* case were payable out of varying proportions of the assignors' oil—6, 8, 25, and 40 per cent and in one instance almost all—and the pay-out periods similarly varied, being 3½ years, 5 years and 8

months, 7 to 8 years, and 10 to 12 years. (See tabulation in Statement, *supra*, n. fn. 7, pp. 11–12.) In the *Wrather* case, the three assigned oil payment rights were payable out of $^9/_{10}$ of the assignor's leasehold oil and were estimated to pay out in from 4 to 6 years. One actually paid out in 4 years and the other two combined in 5 years and 5 months. (Statement, *supra*, pp. 13–14.)

Under these circumstances, it must be concluded that none of the taxpayers' oil (or sulphur) payment assignments transferred such a substantial part of the assignors' leasehold and royalty interests as to warrant treating the consideration received for the assignments as gain derived from a conversion of the increase in the value of those leasehold and royalty interests.

II

IN THE FLEMING CASE, THE SO-CALLED EXCHANGES OF OIL PAYMENT RIGHTS FOR FEE SIMPLE INTERESTS IN REAL ESTATE WERE NOT TAX-FREE EXCHANGES OF PROPERTY OF LIKE KIND WITHIN THE MEANING OF CODE SECTION 112 (b) (1)

In the *Fleming* case, the oil payment assignments were made in return for real estate, rather than for cash. The court below (see *Fleming* opinion, R. 180–187), reversing the Tax Court, held that the transactions were tax-free under Section 112 (b) (1) of the Code (Appendix, *infra*, pp. 59–60), which provides that—

> No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor * * *) is exchanged solely for property of

> a like kind to be held either for productive use in trade or business or for investment.

The inapplicability of this section to the Flemings' oil payment assignments can be demonstrated in several ways.

As we have already shown, the Flemings did not make exchanges of property. They made assignments of future income, which for tax purposes do not constitute transfers of property. While our prior discussion involved Section 117, rather than Section 112 (b) (1), it is unrealistic to suppose that oil payment rights are "property" under a Code provision providing for tax-free transactions if they are not "property" under a Code provision which only accords preferential tax treatment.

Moreover, the language of Section 112 (b) (1) itself seems clearly to preclude treating assignments of future income as exchanges of property. Under that section, the property transferred by taxpayers must be "property held [by taxpayers] for productive use in trade or business or for investment". Such property is necessarily property of the income-producing, and thus capital investment, type. Cf. *Century Electric Co.* v. *Commissioner,* 192 F. 2d 155, 160 (C. A. 8th), certiorari denied, 342 U. S. 954. The underlying assumption of the statute is that the new property is substantially a continuation of the old investment still unliquidated. Treasury Regulations 111, Sec. 29.112 (a)-1 (Appendix, *infra,* pp. 62–63). Accordingly, if the Flemings' oil payment assignments are excludible from the operation of Section 117 as being assignments of future income rather than

transfers of their capital investment (or income-producing) property, the oil payment assignments are excluded from the operation of Section 112 (b) (1) for the same reason. Actually, as already shown (*supra*, pp. 35–36), the Flemings' oil payment assignments were merely arrangements for delayed *cash* payment of the purchase price of real estate plus interest thereon.

The Flemings' oil payment assignments were not transfers of "property held for productive use in trade or business" even apart from the question of whether they were only assignments of future income. The leasehold and royalty interests held by taxpayers were held for productive use in their businesses of producing and selling oil (R. 162, 166), but they did not assign portions of their leasehold and royalty interests as such. They made assignments which created a different type of property interest—oil payment rights. The assigned oil payment rights were of a part of the property represented by taxpayers' leasehold and royalty interests only if and to the extent that they transferred economic ownership of oil in place. If the transfers are of oil, they are expressly excluded from the operation of Section 112 (b) (1) as being of "property held primarily for sale" by taxpayers.

Finally, the oil payment assignments did not transfer property "of a like kind" to real estate. An oil payment right is an "interest in land" only in a rather vague sense; even under Texas law, an oil payment assignment does not convey title to oil in place. *Tennant, Recr.* v. *Dunn*, 130 Tex. 285, 290, 110 S. W.

2d 53, 56. As the court below itself stated long ago in *Standley* v. *Graham Production Co.*, 83 F. 2d 489, 490 (C. A. 5th), certiorari denied, 299 U. S. 593, with respect to an oil payment assignment: "The assignment of this oil *did not create an estate in the land,* but only a lien on the oil after it had been separated from the soil. *Dashko* v. *Friedman* (Tex. Civ. App.) 59 S. W. (2d) 203, and authorities cited therein." (Italics supplied.) An assigned oil payment right is not of the same "nature" or "class" as real estate and that is the basis, as stated in Section 29.112 (b) (1)-1 of Treasury Regulations 111 (Appendix, *infra*, p. 63), for determining whether exchanged property is of like kind. Furthermore, it is implicit in the regulation that, as related to oil interests, only the exchange of "a leasehold of a fee with 30 years or more to run" is sufficiently "like" real estate to constitute a tax-free transaction under Section 112 (b) (1). The court below has itself previously held both that the regulation is valid (*Commissioner* v. *Crichton*, 122 F. 2d 181) and that an oil payment right is not a leasehold or a fee (*Fleming* v. *Campbell*, 205 F. 2d 549, 550).

The present *Fleming* decision (R. 180–187) rests on the same court's decisions in *Commissioner* v. *Crichton, supra,* and *Fleming* v. *Campbell, supra,* as having "decided the question presented here" (R. 187), apparently on the ground that an oil payment right is property "of a like kind" to real estate. However, those decisions have no real bearing on that question. In the *Crichton* case, the exchange was of a *fee* mineral interest for real estate and thus,

as the court below there called it (p. 182), an exchange of "real estate for other real estate". In the previous *Fleming* case, the exchange was of an oil payment right for a royalty interest and accordingly, as the court there stated (p. 550), an exchange "of mineral interests for mineral interests". The fact that a fee mineral interest is property of a like kind to real estate does not also make an oil payment right property of a like kind to real estate. An oil payment right is like a fee mineral interest only in the sense that it is a mineral interest. But a fee mineral interest is like real estate because of its fee characteristic, not because it is a mineral interest. The decision of the court below, holding the *Crichton* and the previous *Fleming* decision controlling here, is thus based on erroneous reasoning.

CONCLUSION

For the reasons stated, it is respectfully submitted that the judgments below should be reversed.

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JANUARY 1958.

APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 22.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

(1) *Property held for productive use or investment.*—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for produc-

tive use in trade or business or for investment.

* * * * * *

(26 U. S. C. 1952 ed., Sec. 112.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) [as amended by Sec. 115 (b) of the Revenue Act of 1941, c. 412, 55 Stat. 687, and Sec. 151 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l) * * * or real property used in the trade or business of the taxpayer.

* * * * *

(4) [as amended by Sec. 150 (a) (1) of the Revenue Act of 1942, *supra*] *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

* * * * * *

(b) [as amended by Sec. 150 (c) of the Revenue Act of 1942, *supra*] *Percentage Taken Into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or ex-

change of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

* * * * *

(j) [as added by Sec. 151 (b) of the Revenue Act of 1942, *supra*] *Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(2) *General rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion * * * of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such

gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *

* * * * * *

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

> SEC. 29.112 (a)-1 [As amended by T. D. 5402, 1944 Cum. Bull. 229]. *Sales or Exchanges.*—* * *
>
> Exceptions to the general rule are made by section 112 (b) (1) to (5), inclusive, * * * in the case of certain specifically described exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Internal Revenue Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.
>
> * * * * *
>
> The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Internal Revenue Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange,

and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

* * * * *

SEC. 29.112 (b)-(1)-1. *Property Held for Productive Use in Trade or Business or for Investment.*—As used in section 112 (b) (1), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose, or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate, or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

* * * * *

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In the Supreme Court of the United States

OCTOBER TERM, 1957

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

P. G. LAKE, INC.

FRANK SCOFIELD, FORMER COLLECTOR OF INTERNAL REVENUE, PETITIONER

v.

DENNIS M. O'CONNOR, ET AL.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WM. FLEMING, ET AL.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN WRATHER, ET AL.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

W. F. WEED, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE PETITIONERS

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---

1. The correctness of our position that taxpayers' oil (or sulphur) payment assignments were assign-

ments of future income, and therefore not entitled to the preferential capital gain treatment accorded by Section 117, is evidenced by the fact that none of the taxpayers even attempts to offer a complete answer to the argument in our main brief (pp. 37–48) based on decisions of this Court relating to oil interests. All of the taxpayers dispute one part of that argument (pp. 37–41) by contending (or assuming) that their oil payment assignments were conveyances of depletable economic interests in the oil in place (*Fleming-Lake* Br. 21–31, 47, 55; *O'Connor* Br. 24, fn. 24, 35; *Wrather* Br. 6; *Wood* Br. 9–10), labelled in one brief as "the sale in bulk of barrels of oil in place" (*O'Connor* Br. 19) and in another brief as conveyances of "present interests in the properties" (*Fleming-Lake* Br. 27, 30, 47, 56). But the fact that a transaction may convey a present interest in property constituting a depletable interest is immaterial, as this Court specifically held in *Burnet* v. *Harmel*, 287 U. S. 103. The oil payment rights which taxpayers created and assigned were not the same type of property interest as the leasehold and royalty interests they owned. Thus, as we argued in our main brief (pp. 42–48), the consideration received for their assignments was, like a lease bonus, "payment in advance for oil and gas to be extracted" (*Herring* v. *Commissioner*, 293 U. S. 322, 324) and therefore taxable as ordinary income subject to depletion, just like a lease bonus. The taxpayers' contention that oil in place is both "tree" and "fruit" (*O'Connor* Br. 17–21; *Fleming-Lake* Br. 30–31; *Wrather* Br. 8) amounts to a contention that the oil is a capital asset,

and this Court plainly rejected that contention in the lease-transfer cases, beginning with the *Harmel* decision. Indeed, it is precisely because taxpayers' oil payment assignments were no more than sales of oil (as contrasted with sales of their oil interests as such) that the consideration received for their assignments is taxable as ordinary income subject to depletion rather than as capital gain.

2. Taxpayer's arguments that their oil payment transactions come within the spirit and purpose of Section 117 (*Fleming-Lake* Br. 48–55; *O'Connor* Br. 14–15; *Wrather* Br. 9, 11) are wholly without merit.

Taxpayers' briefs contain repeated references to other types of transactions, especially transfers of an owner's entire oil interest as such. The distinction between that type of transfer and a transaction which conveys less than the transferor's entire interest (or an undivided portion thereof) was drawn in the lease transfer cases and is fully applicable here. The whole theory of the distinction, never expressly enunciated but implicitly reflected in *Anderson* v. *Helvering*, 310 U. S. 404, 408, is that it is only when the owner of an oil interest sells his entire interest (or an undivided portion thereof), thereby severing his connection with the income derived from the production of oil and losing the depletion deduction through which he would otherwise recover his capital investment, that he converts the form of his capital investment, which he can thereafter recover only through subtraction of the basis of the transferred interest from the amount realized from its sale.

Taxpayers ignore this fundamental distinction, even to the extent of stating (see *O'Connor* Br. 6) that "If the purchaser of a carved out oil payment has purchased a capital asset, as he clearly has, the seller must have sold one." That statement is of course incorrect. An oil and gas lease is also a potential capital asset in the hands of the transferee but under the decisions of this Court the execution or so-called sale of a lease is not a sale of property within the purview of Section 117 when the transferor retains some other type of depletable interest, such as a royalty interest.

The mere fact that Congress intended Section 117 to apply to the sale of "mineral properties" (*O'Connor* Br. 14) affords no basis for applying the statute to a type of transaction which merely accelerates the receipt of future ordinary income from production (and the depletion deduction attributable thereto).* The taxpayers' surprising reliance upon the *Harmel* decision (*supra*) for an argument distinguishing between a single transaction and time-consuming operations resulting in daily sales (*O'Connor* Br. 14–16) ignores the fact that *Harmel* involved but one transaction, the execution of a lease, and held that the lump-sum consideration received for the lease (not just the retained future royalty payments) was taxable as ordinary income subject to depletion rather than as capital gain. The *Harmel* decision itself, as well as the subsequent lease-transfer decisions of this Court (see our main brief, pp. 42–48), furnishes a complete answer to the question posed by taxpayers (*O'Connor* Br. 23) as to whether Congress intended to deny capital-gain treatment to the proceeds received for oil payment rights when the transferor retains an interest in future production instead of selling his entire oil interest as such.

3. Taxpayers assert, however, that administrative practice and judicial precedents prior to 1946 require the conclusion that Congress has, in effect, given im-

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*The term "mineral property" is defined in the regulations as "the mineral deposit [meaning "minerals in place"], the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction." See Treasury Regulations 111, Section 29.23 (m)-1 (b) and (c).

plied approval to such capital gain treatment (*Fleming Lake* Br. 40–46; *O'Connor* Br. 28–30; *Wrather* Br. 11–12). Not one published, pre-1946 administrative ruling specifically relating to the taxation of carved-out oil payment rights is cited. For judicial precedent, three decisions prior to 1946 are cited, two of them (*Ortiz Oil Co.* v. *Commissioner*, 102 F. 2d 508 (C. A. 5th); *Majestic Oil Corp.* v. *Commissioner*, 42 B.T.A. 659), involving situations which may come within a possible exception to our position here (see fn. 19, p. 39 of our main brief), being cases where an oil payment right was given to obtain money to be used for the development of oil properties. The third case (*Nail* v. *Commissioner*, 27 B.T.A. 33), decided in 1932, seems in point, although the facts are not entirely clear.

Administrative practice and judicial decisions can be deemed to have been "ratified" by Congress only if they had crystallized into a clearly formulated rule which was unmistakably brought to the attention of the legislators when they reenacted the underlying statute. See, *e. g.*, *Helvering* v. *N. Y. Trust Co.*, 292 U. S. 455; *United States* v. *Leslie Salt Co.*, 350 U. S. 383. Section 117, first enacted in 1921, has been in continuous effect in substantially the same language, but Congress certainly cannot be deemed to have been aware of, much less to have given approval to, a pre-1946 administrative practice relating to carved-out oil payment rights which was not reflected in any published ruling. Moreover, administrative practice "gives way before changes in the prior rule or practice through exercise by the administrative agency

of its continuing rule-making power." *Helvering v. Reynolds*, 313 U. S. 428, 432.

Whatever may have been the Commissioner's pre-1946 view regarding assignments of carved-out oil payment rights, he made no published ruling on the subject until 1946, shortly after assignments of carved-out oil payment rights began to have "widespread usage" in the oil industry "as a device to turn ordinary income into capital gain" (32 Taxes, Tax Magazine 494, 496). Then, noting that the assignments were usually of short duration, it was ruled that assignments of so-called "short-lived in-oil payment rights" are assignments of future income (as distinguished from sales of property under Section 117); a decision regarding assignments of long-lived oil payment rights was specifically reserved, the ruling stating that "No opinion is expressed with respect to the status of in-oil payment rights extending over a substantial portion of the life of the depletable economic interests from which such rights are carved." See G. C. M. 24849, (1946–1 Cum. Bull. 66, 69), printed in the *Fleming-Lake* brief at pages 117–124. In 1950, when advice was requested as to the phrase "short-lived in-oil payment rights" as used in G. C. M. 24849, the Commissioner, stating that it had been concluded that there was no legal or practical basis for distinguishing between short-lived and long-lived oil payment rights, ruled that the transfer of any carved-out oil payment right (not pledged for development) which extends over a period less than the depletable life of the property interest from which it is carved is an assignment of future income. See I. T. 4003

(1950-1 Cum. Bull. 10), printed in the *Fleming-Lake* brief at pages 125-126. If Congress has approved any administrative practice or view, it is the one reflected in the published rulings beginning in 1946. Cf. *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90.

4. Contrary to the implication contained in the *Fleming-Lake* brief (pp. 40, 45–46), the Commissioner is not here attempting to give "retroactive effect" to a "change in position." The earliest oil payment assignment involved here was made on December 24, 1947, which was after taxpayers had been put on notice, not only by the lease-transfer decisions of this Court but by G. C. M. 24849, that the consideration received for the assignment of any carved-out oil payment right might be held to be an assignment of future income. Plainly, the Commissioner's reservation in G. C. M. 24849 of a ruling as to assignments of long-lived oil payment rights (*supra*, p. 6) cannot be treated as if he had in fact affirmatively ruled that such assignments were to be accorded capital-gain treatment.

5. The argument that the Commissioner's position results in two depletion allowances on the same income (*Fleming-Lake* Br. 55–59) is erroneous. As already pointed out, the consideration received for an oil payment assignment by the owner of a leasehold or royalty interest is, like a lease bonus, payment in advance for oil to be extracted. It is therefore depletable by the assignor and, as in the case of a lease bonus (see Treasury Regulations 111, Section 29.23 (m)-1 (f)), the amount thereof may not be included in the assignee's base for percentage depletion pur-

poses (assuming that the assignee of a carved-out oil payment right receives a depletable economic interest in the oil in place). It follows that the assignee is entitled to percentage depletion on no more than the excess of the amount of the oil payments received over the amount of the consideration paid to the assignor (see our main brief, fn. 17, p. 37).

As a practical matter, the assignee will only rarely be entitled to take percentage depletion, since cost depletion (as in these cases) will almost always be higher than percentage depletion and the statute requires cost depletion where that is true. See Section 114 (b) (3) of the 1939 Code (26 U. S. C. 1952 ed., Section 114). Thus, the taxpayers' assignees will exclude, from their gross income received in connection with their oil payment rights, the total amount paid to the taxpayers for those rights. But to call this exclusion of cost a "depletion allowance" is misleading; for such cost would be tax-free irrespective of whether there existed a special oil depletion deduction and, indeed, irrespective of whether the oil payment rights even constituted a depletable economic interest. A "depletion allowance" of this nature is nothing more than a tax-free recovery of capital and is available to any transferee, not merely the assignee of an oil interest. See Sections 111 (a) and 113 (a) of the Code (26 U. S. C. 1952 ed., Sections 111 and 113).

Accordingly, aside from the fact that the Commissioner's position does not result in a double depletion allowance on the same income, the question of depletion as to the assignee is largely academic. The controlling considerations are that, regardless of

whether the assignee receives a depletable interest, the consideration received by the assignor for the oil payment assignment is depletable by the assignor as representing anticipatory oil proceeds (whether treated as a sale of oil or of a mere contractual right to receive future oil proceeds), the depletion deduction compensates the assignor for whatever loss of capital investment is occasioned by the oil payment assignment, and as to the assignor the transaction is only an assignment of future income.

It is respectfully submitted that the judgments in all five cases should be reversed.

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MARCH 1958.

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No. 921

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1956

Commissioner of Internal Revenue,

Petitioner

vs.

Wm. Fleming and Bessie M. Fleming (Husband and Wife), F. Howard Walsh and Mary D. Walsh (Husband and Wife), and Mary D. Fleming Walsh,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Opinions Below

The opinion of the Court of Appeals is reported at 241 F. 2d 79. The opinion of the Tax Court is reported at 24 T. C. 818.

Jurisdiction

The judgment of the Court of Appeals was entered on February 1, 1957. Petitioner invoked the jurisdiction of this Court under 28 U.S.C., Section 1254.

Questions Presented

Should this Court entertain a petition for certiorari to review a holding of a Court of Appeals which was not dispositive of the case sought to be reviewed?

The question presented by the dispositive holding is whether the exchanges of limited overriding royalty, or oil payment, interests in producing oil properties for ranching lands and urban business property were exchanges of properties of "a like kind" within the meaning of *Section 112(b)1)* of the Revenue Act of 1939, as the Court of Appeals held.

The non-dispositive question is whether, if gain from such an exchange is to be recognized for income tax purposes, it is to be taxed as capital gain under *Section 117* of the Internal Revenue Code of 1939.

Statute and Regulations Involved

The pertinent provisions of the Internal Revenue Code of 1939 (Sections 112(b)(1), 117(a)(1) and (4) and (j)(1)(2) and of Treasury Regulations 111 (Sec. 29.112(b)(1)-1) are set forth in the Appendix hereto, pp. 13 to 18.

Statement

Fleming and associates exchanged limited overriding royalty, or oil payment, interests carved out of producing oil and gas properties for a ranch. They had held the oil and gas properties for productive use in their business of producing oil and gas; they acquired and held the ranch for investment. The market value of the ranch when so acquired exceeded the tax bases of the overriding royalties in the hands of Fleming and associates. Fleming and associates reported no taxable gain from the exchange (R. 86-92).

The Commissioner of Internal Revenue determined that the exchange produced ordinary income subject to depletion. The taxpayers involved appealed to The Tax Court of the United States assigning this action as error and taking the position that no gain from the exchange should be recognized for tax purposes because the properties were of like kind within *Section 112(b)(1)* of the 1939 Code. Alternatively, they sought a holding that, if any gain was to be recognized, it should be taxed as capital gain under *Section 117* of said Code. (R. 5-6, 26, 27, 46, 47). The Tax Court held that *Section 112(b)(1)* of said Code was not applicable but that the gain was to be taxed as capital gain (R. 83).

On cross-appeals to the United States Court of Appeals for the Fifth Circuit, the Court held that the exchange was of properties of a like kind within the meaning of said *Section 112(b)(1)* so that no gain

was to be recognized for income tax purposes. (Page 91, Appendix, Petition for Certiorari). After so holding, the Court said:

> "If we assume that we are in error in this view, and we, therefore, reach * * * (the capital gain issue) * * * raised on the commissioner's appeal * * * we find ourselves in agreement with the tax court, and, for the reasons set out in *Scofield v. O'Connor* and *Lake v. Commissioner*, this day decided, we affirm its judgment on this issue." (Page 98, Appendix, Petition for Certiorari).

The overriding royalty interests given in exchange for the ranch were evidenced by four assignments (R. 86 to 91). They were similar except for amounts and properties. One classified by the Court below as typical was thus analyzed and summarized in its opinion. (See footnote 3, pp. 92-94, Appendix, Petition for Certiorari).

> "The assignment from Fleming Oil Co. is typical and only its pertinent terms will be set out. It involved four ordinary commercial oil and gas leaseholds in which Fleming Oil Company was then the owner of an undivided one-half interest; and recited that for a valuable consideration Fleming Oil Company conveyed to Mrs. Cline:
>
> > 'The following described real property, to wit, an overriding royalty or mineral interest carved out of the interest owned by Fleming Oil Company in each and all of the oil and gas leases above described, amounting to an un-

> divided 48 128 interest in and to all of the oil in, under and that may be produced, saved and marketed from the above described tracts of land under the terms of the oil and gas leases covering the same, until the grantee above named shall have received therefrom oil of the net value of $147,000, plus an amount equal to 5% interest per annum from May 19, 1948, on the portions of the said $147,000 which may be unsatisfied from time to time.'

The instrument further provided that no interest in gas, casinghead gas or in the personal property then on or thereafter placed upon the property was conveyed; that grantee was to be entitled to receive the amount specified from the fractional part of the oil conveyed in addition to such gross production or severance taxes as might be imposed thereupon; that the conveyance was effective June 1, 1948; that all development and operating costs and expenses were to be borne by Fleming Oil Company; and that, when the grantee had received oil of the net value specified, her interest was to terminate. The instrument also provided:

> 'The execution of this conveyance shall not impose upon grantor any obligation with respect to developing or operating the property covered hereby, nor shall it be implied herefrom the grantor is in anywise obligated to see that grantee receives oil aggregating the net value of $147,000, plus an amount equal to 5% as above provided, or any lesser sum; but grantor does covenant and agree that

> grantee shall have the same but no greater right to require the grantor to develop and operate said property, in accordance with the terms of the original lease upon said property, as the original lessors therein, their heirs or assigns, might have or exercise.' "

The time of the "pay-out" or probable duration of the assigned overriding royalties, estimated from data in the record showing sums made available up to the close of the year 1952 was 5-2 3rds years as to one, 7 to 8 years as to two and 10 to 12 years as to the fourth (R. 88, 89, 90, 91, and footnote page 94, Appendix, Petition for Certiorari).

There is also involved a transaction between taxpayer Walsh and one Cross similar in all respects to the one just summarized, except that Walsh received in the exchange urban business property and the estimated pay-out of the overriding royalty which he assigned therefor was 3-1 2 years. It was treated as was the transaction of Fleming and associates by Walsh, by the Tax Court and by the Court of Appeals. (Footnote page 94, Appendix, Petition for Certiorari).

Reasons For Refusing The Writ

1.

The capital gain issue is the only issue in the other four "entirely separate proceedings" (p. 1 Petition for Certiorari) which were joined by the Commissioner

of Internal Revenue with this case in a single Petition for Writs of Certiorari.[1] Capital gain is, at most, only a secondary issue in this case. The dispositive issue in this case is whether what was stipulated to be "an exchange" consummated "in accordance with a pre-existing agreement so to do" (R. 112-118)[2] was an exchange of properties "of like kind" within the meaning of Section 112(b)(1) of the Internal Revenue Code of 1939. Only if it is held that the exchanged properties were not "of like kind" will it be appropriate or necessary to determine if the exchange produced gain taxable as long-term capital gain. The Petition for Certiorari makes only the briefest reference to this "non-taxable exchange" issue. At page 3 of the petition, after stating that the capital gain question is the "general question" the "non-taxable exchange" question is stated and classified as an "additional related question." In footnote 11, page 16, the petition further states:

> "The *Fleming* case below (Appendix B, infra, pp. 91-98) also involves another question which is intimately connected with the principal issue. In Fleming, the taxpayers received a fee simple interest in real estate in exchange for an oil pay-

---

[1] *Commissioner v. P. G. Lake, Inc.*, 24 T.C. 1016, aff'd. 241 F. 2d 71, *Scofield v. O'Connor*, 143 F. Sup. 240, aff'd. 241 F. 2d 65; *Commissioner v. Weed* (T C M) 241 F. 2d 69; *Commissioner v. Wrather* (T C M) 241 F. 2d 84.

[2] It was also stipulated that the other requisites to the application of Section 112(b)(1),—that the properties exchanged be held for productive use in trade or business or for investment—were present (R. 113, 118).

ment right. Reversing the Tax Court, the Court of Appeals (Judge Borah dissenting) held that this was a non-taxable exchange of 'property' of like kind under Code Section 112(b)(1), (Appendix B, infra, pp. 94-98). The Court went further and stated that, if it was wrong in this conclusion, the gain was taxable as capital gain (Appendix B infra, p. 98)."

The petition nowhere asserts that the holding of the Court below on the applicability of *Section 112(b)(1)* of the 1939 Code conflicts with any holding of this Court or of any other Appellate Court, or that the question is important, or that the issue was wrongly decided, or otherwise presents a situation coming within *Rule 19.1(b)* of this Court. In fact, there is no conflict, the question is not important and the situation does not come within any of the provisions of said rule. If support other than the opinion below is needed for the assertion that the issue was correctly decided there, it can be found in the Treasury Regulation (Appendix, infra p. 17) ruling that the question of likeness is to be determined by the nature or character of the property and not by its grade or quality, and the Commissioner's own rulings that oil and gas leaseholds and other mineral interests are like in kind to fee lands. (*I. T. 4093, 1952-2 C.B.*, p. 130), and that perpetual water rights are like in kind to fee lands (Revenue Ruling 55-749, 1955-2 C.B., p. 295), so that the specified properties may be exchanged without recognition of gain or loss.

The substance of the provisions of *Section 112(b)(1)* of the Code has been contained in all Revenue Acts since that of 1924,[3] and has been carried forward as *Section 1031* of the Internal Revenue Code of 1954. In this period of approximately 33 years, only three cases (including this case) involving the application of the statutory provisions to exchanges of oil properties of any kind have reached an Appellate Court. All were decided by the United States Court of Appeals for the Fifth Circuit in favor of the applicability of the Section. The other two are:

1. *Commissioner v. Crichton*, 112 F. 2d 181, decided in 1941, involving the exchange of mineral interests for a hotel property.

2. *Fleming v. Campbell*, 205 F. 2d 549, decided in 1953, involving the exchange of a limited overriding royalty or oil payment out of an oil and gas leasehold for a perpetual mineral or royalty interest.

The amounts involved in all of these proceedings combined is minuscule compared with the amounts involved in most tax questions.[4]

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[3] Sec. 203(b)(1) Rev. Act of 1924; Id. Rev. Act of 1926; Sec. 112(b)(1) Rev. Acts of 1928, 1932, 1934, 1936, 1938.

[4] The question has reached the Tax Court and the Board of Tax Appeals only four times, in addition to the present case:—*Midfield Oil Company*, 39 B T A 1154; *Kimbell*, 41 B T A 940; *Bandini Petroleum Co.*, 10 T C M 999; *Horsting*, 5 T C M 421.

Under *Rule 19.1-(b)* of this Court, the Petition for Certiorari should be denied.

2.

The capital gain section *(Section 117)* and the non-taxable exchange section *(Section 112(b)(1))* of the 1939 Code are not structually connected or otherwise closely related. The Court below could have held, and this Court could hold, that the disposition of the over-riding royalty interests involved in any of the other four cases covered by the Petition for Certiorari for cash or in satisfaction of a money obligation did or did not produce capital gain, and that would not answer the question of whether the real estate received by respondents in this case, in what was stipulated to be an exchange (R. 112) was like in kind to the over-riding royalty interests which they exchanged. "Likeness in kind" is the issue in this case.

Different criteria control the applications of the sections. It seems obvious that *Section 112(b)(1)* was enacted to permit, within the limitations contained therein, dispositions of property which did not produce money or obligations expressed and convertible into money without the recognition of gain so that a taxpayer making such an exchange would not be required to resort to other sources to pay the tax. The

practical and intended effect is to defer taxation until something from which the tax can be paid is realized.

While the capital gain provisions were no doubt originally designed to avoid taxing at progressive rates in the year of sale what was actually the enhancement in value of the property sold over a period of years, this has not been the case since the holding period requisite to long-term capital gain treatment has been reduced to six months. Now, particularly since the law has been expanded to limit the deductibility of both long-term and short-term capital losses, it must be recognized that the capital gain and loss provisions are designed to produce revenue by encouraging dealings in capital assets and to protect the revenue by limiting the extent to which capital losses can be used to off-set ordinary income.

Thus, if the assertion in the Commissioner's petition that a conflict exists on the capital gain question is sustained, and this case brought to this Court for review, the question can be reached in this case only if, and after, the dispositive holding that gain from the exchanges is not to be recognized (which holding is not attacked by the Commissioner) is set aside. Such action would not tend to solve the capital gain question.

In a non-taxable exchange the taxpayer takes as his tax basis in the acquired property the basis which he had in the property disposed of. *Section 113(a)(6)* 1939 Code. Thus, when the acquired property is disposed of, the gain attributable to the first property, as well as that attributable to the second, is taxed.

3.

If it could be assumed that this case is to be considered on this Petition for Certiorari as if the "nontaxable exchange" question were not involved, and as if the Court below had merely affirmed the Tax Court's holding on capital gain, then these respondents adopt, without repetition here, the reply to the Petition for Certiorari filed on behalf of P. G. Lake, Inc. which company is represented here by the same counsel who represents respondents in this proceeding.

Conclusion

For the foregoing reasons, it is respectfully submitted that the Petition for a Writ of Certiorari in this case should be denied.

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APPENDIX

Internal Revenue Code of 1939:

"SEC. 112. RECOGNITION OF GAIN OR LOSS.

" * * *

"(b) Exchanges Solely in Kind.—

"(1) Property held for productive use or investment.—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment."

"SEC. 117. CAPITAL GAINS AND LOSSES.

"(a) Definitions.—As used in this chapter—

"(1) *Capital Assets.*—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

"(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

"(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), or real property used in his trade or business;

"(C) a copyright; a literary, musical, or artistic composition; or similar property; held by—

"(i) a taxpayer whose personal efforts created such property, or

"(ii) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property; or

"(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1,

1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

" * * * *

"(4) *Long-Term Capital Gain.*—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income:

" * * * *

"(j) Gains and Losses from Involuntary Conversion and from the Sale or Exchange of Certain Property Used in the Trade or Business.—

"(1) *Definition of Property Used in the Trade or Business.*—For the purpose of this subsection, the term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copyright, a literary,

musical, or artistic composition, or similar property, held by a taxpayer described in subsection (a)(1)(C). Such term also includes timber or coal with respect to which subsection (k)(1) or (2) is applicable and unharvested crops to which paragraph (3) is applicable. Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such terms does not include poultry.

"(2) *General Rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *".

Treasury Regulations 111:

"Sec. 29.112(b)(1)-1. *Property held for productive use in trade or business or for investment.* —As used in section 112(b)(1), the words 'like kind' have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

"No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose, or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate; or improved real estate for unimproved real estate, or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

"A transfer is not within the provisions of section 112(b)(1) if as part of the consideration the other party to the exchange assumes a liability of the taxpayer, but such transfer, if otherwise qualified, will be within the provisions of section 112 (c).

"Gain or loss is recognized if a taxpayer exchanges (1) Treasury bonds maturing October 15, 1945, for Treasury bonds maturing June 15, 1963, or (2) a real estate mortgage for bonds of the Home Owners' Loan Corporation."

Office-Supreme Court, U.S.
FILED
MAY 15 1957
JOHN T. FEY, Clerk

No. ~~921~~ 103

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1956

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

P. G. LAKE, INC.,
Respondent.

BRIEF IN OPPOSITION TO PETITION FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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COMMERCIAL RECORDER, FORT WORTH, TEXAS 5-14-57 60

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No. 921

IN THE

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OCTOBER TERM, 1956

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v.

P. G. LAKE, INC.,
Respondent.

BRIEF IN OPPOSITION TO PETITION FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 241 F. 2d 71. The opinion of the Tax Court is reported at 24 T.C. 1016.

JURISDICTION

The judgment of the Court of Appeals was entered on February 1, 1957. Petitioner invoked the jurisdiction of this court under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Is the gain received by the respondent, P. G. Lake, Inc., for the sale of a limited overriding royalty or oil-payment interest out of two commercial oil and gas leases which the respondent had held for several years for productive use in its trade or business of producing oil, and not for sale, to be taxed as long-term capital gain, as was held below; or as ordinary income subject to depletion, as the Commissioner of Internal Revenue unsuccessfully contended below?

STATUTES INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 are set forth in Appendix A, *infra*, pages 28 to 35. They are as follows: Section 23(m); Section 114(b)(3); and Section 117(a)(1) and (4), (b) and (j)(1) and (2), of the 1939 Code.

STATEMENT

Respondent, P. G. Lake, Inc., is a corporation engaged in the business of producing oil and gas. The transaction in question occurred on December 29, 1950. On that date, P. G. Lake, Inc., in consideration

of the cancellation of an indebtedness of $600,000 owed by it to its president, P. G. Lake, conveyed a limited overriding royalty or oil-payment interest to Lake out of two commercial oil and gas leases which the company had owned for several years and had held for productive use in its trade or business of producing oil, and not for sale. (R. 30-31).

This instrument conveyed to the grantee, "such an interest in said oil and gas leases and each of them, so that the said P. G. Lake, Grantee, shall own twenty-five per cent of seven-eights (25% of 7/8ths) of all oil and gas in, under or upon such leases and each of them, and shall be entitled to receive twenty-five per cent of seven-eighths (25% of 7/8th) of all the oil, gas and other minerals produced, saved and marketed from the above described oil and gas leases and leasehold estates, from and after 7:00 a.m. January 1, 1951, until said Grantee, his heirs and assigns, shall have received by virtue of this interest the sum of $600,000 net to him after the payment of all pipe line and gross production taxes attributable to said interest, plus an amount equal to interest at the rate of three per cent (3%) per annum payable monthly on the entire balance of said original sum remaining from month to month unsatisfied." (R. 33) The entire instrument, omitting field notes, signatures and acknowledgments (R. 32-35 is shown in a footnote[1] to this statement.

Footnote: [1]
STATE OF TEXAS
COUNTY OF SMITH

WHEREAS, P. G. Lake, Inc., a corporation, is the owner of certain oil, gas and mineral leases located in Gregg and Rusk Counties, Texas, and briefly described as follows:

Lease No. 1

A certain oil, gas and mineral lease known as the Mrs. V. E. Reid Lease, and covering the following described property located in Rusk County, Texas, to wit:

(Field notes omitted)

Lease No. 2

A certain oil, gas and mineral lease given by J. P. Owens and wife Willie Owens to J. A. Reynolds, on August 1, 1930, and duly recorded in Volume 78, page 394, Gregg County Deed Records, and which oil and gas lease covered certain lands located in David Meredith Survey, Abstract 131, and the Charles P. Hereford Survey, Abstract 106, located in Gregg County, Texas, the properties covered by said oil and gas lease, by a recent survey of same, being described as follows:

(Field notes omitted)

NOW, THEREFORE, KNOW ALL MEN BY THESE PRESENTS:

That P. G. Lake, Inc., acting herein by and through its proper officers, thereunto duly authorized by a resolution of its Board of Directors hereunto duly passed and entered, hereinafter referred to as Grantor, for and in consideration of the sum of Ten Dollars ($10) and other good and valuable consideration to it in hand paid by P. G. Lake, hereinafter referred to as Grantee, the receipt of which is hereby acknowledged, does hereby Bargain, Sell, Assign and Convey unto the said Grantee, his heirs and assigns, such an interest in said oil and gas leases, and each of them, so that the said P. G. Lake, Grantee, shall own twenty-five per cent of seven-eights (25% of 7/8ths) of all the oil, gas and other minerals produced, saved and marketed from the above described oil and gas leases and leasehold estates, from and after 7:00 a.m. January 1, 1951, until said Grantee, his heirs and assigns, shall have received by virtue of this interest

the sum of Six Hundred Thousand Dollars ($600,000), net to him after the payment of all pipe line and gross production taxes attributable to said interest, plus an amount equal to interest at the rate of three per cent (3%) per annum payable monthly on the entire unpaid balance of said original sum remaining from month to month unsatisfied.

The 25% of 7/8ths of the oil and gas thereby assigned to said Grantee shall be forever free and clear of any expense of developing, maintaining or operating said leasehold estates, and all costs of producing and marketing said products shall be borne by Grantor, and Grantor shall save and hold Grantee forever harmless of any such costs. Grantor shall likewise promptly pay off and discharge all ad valorem taxes that may be assessed against the interest hereby conveyed to Grantee, and the proceeds of said 25% of 7/8ths of the gross production shall be paid directly to the said Grantee, his heirs and assigns, by any pipe line company or other purchaser of oil or gas from said premises.

The parties hereto shall, from time to time, execute such transfer orders, division orders, or instruments of like character necessary in order to carry into effect the terms and provisions of this conveyance and to facilitate the orderly handling, transportation and sale of the oil and gas produced from said leases.

And when the Grantee shall have received the full net sum of $600,000 plus an amount equal to interest thereon as hereinabove provided for, from the proceeds of the sale of 25% of 7/8ths of all of the oil and gas produced and saved from the above described leases, then this conveyance shall terminate and the interest hereby assigned shall revert to and revest in the Grantor, its successors and assigns, and Grantee shall execute and deliver an instrument of reconveyance of said interest, and any such other papers as may be necessary to replace the title in Grantor.

TO HAVE AND TO HOLD the above described interest unto the said P. G. Lake, his heirs and assigns, forever, subject to the terms and conditions of this conveyance.

In accordance with the terms of the conveyance, transfer orders in the usual form were executed and delivered to the pipe line companies which were then running and purchasing the oil produced from said properties. These transfer orders (introduced in evidence in the Tax Court as the taxpayer's exhibits 2 and 3, R. 28, but by stipulation transmitted to the Court below in original form and not printed in the record, R. 92-93) recognized the ownership by P. G. Lake of the percentage of the oil and gas specified, and directed that he be paid the purchase price of that share of oil and gas until he had so received oil and gas of the value specified in said conveyance. This was done. In February 1954, P. G. Lake had received oil and gas of the specified value and he then executed and delivered to P. G. Lake, Inc. an instrument evidencing this. (R. 35-36).

It could have been estimated with reasonable accuracy on December 29, 1950 that it would require three years or more for the said oil and gas leases to produce sufficient quantities of oil and gas so that 25% of 7/8ths thereof would have a value equal to the

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This instruments is executed in duplicate, each of which, for the purpose of filing, shall be considered as an original. This is done to facilitate filing both in Gregg County and Rusk County.

IN TESTIMONY WHEREOF, P. G. Lake, Inc. has caused this instrument to be executed by its Vice-President, attested by the Secretary, and the corporate seal affixed thereto, this the 29th day of December, 1950.

(Signatures and Acknowledgments Omitted.)

amount of oil and gas to which P. G. Lake was entitled under the conveyance. (R. 36).

P. G. Lake, Inc. reported this transaction in its 1950 income and excess profits tax return, as one producing long-term capital gain in the amount of the consideration ($600,000) less $660, representing the cost of United States documentary stamps affixed to the instrument. (R. 36). Upon reviewing this tax return, the Commissioner of Internal Revenue determined:

> "The $599,340 represents net amount received from sale of oil payment to P. G. Lake in December 1950. The amount is reported on return as sale of capital assets. It is held to be the advance sale of oil and taxable as ordinary income in accordance with General Counsel's Memo 24849, Internal Revenue Cumulative Bulletin 1946-1, p. 66. Depletion is allowed on this income in adjustment (d) below." (R. 36-37).

P. G. Lake, Inc. sought a review of this determination by the Tax Court of the United States, alleging that the gain in question was taxable as long-term capital gain under Section 117 of the Internal Revenue Code of 1939. (R. 5). In a unanimous opinion reviewed by the entire Tax Court, it was held that the gain was taxable as long-term capital gain. (R. 52-60). On the Commissioner's petition for review by the United States Court of Appeals for the Fifth Circuit, the Tax Court was affirmed. (Petition for Certiorari, pages 69 and 107).

REASONS WHY THE PETITION FOR CERTIORARI SHOULD BE DENIED

The petition assigns as the reasons why the writ should be granted:

1. A conflict, primarily with *Commissioner v. Slagter*, 228 F. 2d 901, decided by the United States Court of Appeals for the Seventh Circuit on November 29, 1956;

2. That the holding below was erroneous; and

3. That an important tax question is presented which should be decided by this Court.

After a preliminary discussion, we shall reply to these points in their reverse order.

Preliminary

While the business of producing oil and gas bears some resemblance to a manufacturing business, it is in truth *sui generis*. The right to explore for and produce oil or gas, sometimes termed "oil and gas in place" is everywhere recognized as a valuable property right. Oil and gas when severed by production constitute income, so that the full value thereof, or the amount realized therefrom, constitutes taxable income, from which only such items as the grace of Congress specifies can be deducted in determining the amount

taxable as net income.[2] Thus, since an oil or gas reserve is irreplaceable, the conduct of an oil or gas producing operation to exhaustion destroys the capital initially represented by the oil and gas reserve. Only as to the production of natural resources is such a tax theory applicable.

To ameliorate the hardship of such a taxing theory, Congress, in addition to allowing the oil producer to deduct expense outlays, has granted a deduction for depletion which is based on cost of the reserve or, since 1926, on a percentage of the gross income derived from production. The latter, "percentage depletion," is the more commonly used. This allowance is 27½% of the "gross income from the property" but not more than 50% of the net income therefrom calculated without the depletion allowance.[3]

A long line of cases by this Court has firmly established the principle that this depletion allowance, which in the aggregate can never exceed 27½% of the gross income from the property,[4] must be allocated among all those who by virtue of an economic interest share in the production or the proceeds thereof, whether this interest is because of fee ownership,

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[2] Merten's Law of Federal Income Taxation, Vol. 4, para. 24.02, and cases cited in footnotes 3 and 5, including *Anderson v. Helvering*, 310 U.S. 404, 407.

[3] Sec. 114(b)(3), I.R.C. 1939, Appendix, *infra*, p. 35. There has been substantially no change in this provision since 1926.

[4] *Helvering v. Twin Bell Oil Syndicate*, 293 U.S. 312.

a royalty or unlimited overriding royalty interest, a lessees interest, a "net profit" interest, or a limited overriding royalty or oil-payment interest.[5]

Both expressed and implied in the depletion decisions, is the related principle that "gross income from property" upon which one taxpayer's depletion allowance is based is a part of that taxpayer's gross income for all other income tax purposes and cannot be a part of any other taxpayer's taxable income from the property.[6]

It has been necessary, in administersing the various Acts, to apply these principles to many different types of transactions. Two particularly pertinent here are: (1) The sale of the property, with the seller reserving a share of the oil or gas to be produced during the life of the property or until oil or gas of a specified amount or of a specified value has been produced; and (ii), the assignment by the owner of a property to another, of one or the other of such interests. These interests are usually called overriding royalty inter-

[5] The latest holding by this Court is *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308; others include *Thomas v. Perkins*, 310 U.S. 655; *Kirby Pet. Co. v. Commissioner*, 326 U.S. 599; *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25.

[6] See cases cited in footnote 5, and *Anderson v. Helvering*, 310 U.S. 404, which establishes the principle that receipts applicable to a reserved oil payment, so called, which could be satisfied otherwise than from oil and gas when, as and if produced was not a depletable interest so that receipts were the income of the assignee who acquired the properties.

ests where they are to continue for the productive life of the property, and limited overriding royalty or oil-payment interests where they are limited by value or amount to a probable shorter duration. Those arising under method (i) above are ordinarily called "retained" and those arising under method (ii) "carved out."

For many years the Internal Revenue Service made no distinction between such "retained" and "carved-out" interests. All were recognized as "depletable" interests. Other statutory requirements (holding period, etc.) being present, the carving-out of any such interest for a consideration was held to produce long-term capital gain, as was the disposition of such a retained interest. In 1946, with no statutory change and with no Congressional or judicial disapproval of the existing practice,[7] a General Counsel's Memorandum attempted to change the applicability of these established principles as to the taxation of the gain from the disposition of "short-lived" carved-out oil payments only, by ruling that this gain was taxable as ordinary depletable income (provided the proceeds were not pledged to the development of the property, in which case the position of the Service was, and is,

[7] That such a carving out was a sale of an interest in the property and not productive of ordinary depletable income, had been expressly held in *Ortiz Oil Co. v. Commissioner*, 37 B.T.A. 656 (1938), affd. 102 F. 2d 508 (1939), cer. den. 308 U.S. 566, discussed at p. 25, *infra*.

that no income was received). Later, the rule was extended to any carved-out oil payment which did not extend for the probable life of the property and was, therefore, not an overriding royalty interest.[9] These rulings provoked the controversy now before the Court. But no change was, or even has been made, in the treatment of overriding royalties, retained or carved-out, or of retained oil payments.[10] So the po-

[9] *G.C.M. 24,849* 1946-1 C.B. p. 66, reproduced in full in the Appendix, infra, pp. 36 to 42. Particular attention is directed to the statements that a "short-lived" oil payment "ordinarily pay(s) out and expire(s) within one or two years"; that all oil payments are depletable economic interests in the property; and that "The issue presented * * * should not be confused with the question presented in such cases as *Lucas v. Earl* (281 U.S. 111), *Helvering v. Horst* (311 U.S. 112) and *Helvering v. Eubank* (311 U.S. 122), involving donative assignments of income * * *. There the earner-assignor attempts to avoid realization of expected income. Here the assignor expedites such realization."

I.T. 4003, Cumulative Buletin 1950-1, p. 10, reproduced in full in the Appendix, p. 42 *infra*. In *G.C.M. 24,849* (see footnote 8, *supra*, no opinion was "expressed with respect of in-oil payment rights extending over a substantial portion of the life of the depletable economic interests from which such rights are carved." But four years later, with no citation of authority, judicial or legislative, the rule was announced that "there is no legal or practical basis for distinguishing between short-lived and long-lived in-oil payment rights.

[10] Certain principles will not be questioned by the Commissioner or his counsel. They are being applied every day in the administration of the tax laws and are universally accepted. Among them are these:

(i) The assignment of an oil and gas lease, with an overriding royalty retained, is treated as a sub-lease. The cash consideration is treated as ordinary depletable

sition of the Commissioner here must be that he has the right *sua sponte*, to change the administrative practice which had received Congressional and judicial approval, and to hold that the mere fact that the carved-out interest is limited by some standard other than the economic life of the property makes such a carving-out transaction, and that transaction alone, something other than a sale of property; at the same

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income. The overriding royalty is a depletable economic interest.

(ii) The assignment of an oil and gas lease, with a limited overriding royalty, or oil payment, retained, is treated as a sale of a part of the lease. The consideration is not depletable income but sale proceeds taxable as capital gain if the other statutory requirements are met. The oil payment is a depletable economic interest.

(iii) The assignment of the retained overriding royalty (example (i) above) or the retained oil payment (example (ii) above), or an interest in either co-extensive with its remaining life, is a sale producing non-depletable income taxable as capital gain if other statutory requirements are met. The assignee acquires a depletable economic interest.

(iv) The carving out and sale of an overriding royalty produces non-depletable income taxable as capital gain if other statutory requirements are met—as does any subsequent sale of the carved-out interest or a part thereof co-extensive with its remaining life.

(v) Irrespective of how the point involved in the present controversy (the treatment of the consideration received for a carved-out oil payment) may be decided, subsequent assignments of the carved-out oil payment or an interest therein co-extensive with its remaining life produce non-depletable income taxable as capital gain if other statutory requirements are met.

time recognizing that the carving-out of an unlimited overriding royalty is such a sale.[11]

1.

As To the Importance of the Question

The assertion (Petition for Certiorari, p. 21) that there will be an "estimated loss to the revenue of many millions of dollars" if the decision below is permitted to stand is challenged.

Practically every tax rule is a two-edged sword—a tax burden imposed thereby on one opens the way for tax relief to another. So here. If the sale of an oil payment is taxed as a capital-gain transaction, the gain is not depletable income to the seller, nor does it enter into his calculation of the 50% limitation on allowable depletion. (See Section 114(b)(3), I.R.C. of 1939, *infra* p. 35). But under the principle advocated by the Commissioner, the proceeds of such a sale are, in their entirety, treated as depletable income and they enter into calculation of the 50% limitation on allowable percentage depletion. Thus, it is possible under the Commissioner's theory—particularly as to a property in the development stage with resultant large deductions for development expenditures—to bring into a particular year, income which

[11] That the Commissioner does not have the right to change long-continued administrative practices without Congressional approval was expressly held by this Court in a very similar situation. *U. S. v. Leslie Salt Company*, 350 U.S. 383.

would ordinarily be realized in later years and thereby obtain the full depletion allowance on that income plus the normal income from the property for the year; whereas, if G.C.M. 24,849 is inapplicable, the depletion on the normal income for the year would be lost because of the 50% limitation. Only to the Commissioner are data available to calculate how much the revenue suffers from use by taxpayers of his theory, but it is confidently asserted that it equals the "many millions of dollars" which he asserts will be lost to the revenue by the application of the capital gain theory which he here opposes. The "43 docketed and undocketed cases" presenting the capital gain issue (Petition for Certiorari, p. 21) is an insignificant number when considered in connection with the number of taxpayers engaged in producing oil and gas. Nor should it be forgotten that an express purpose of the capital-gain section is to reduce taxes.[12]

2.

The Holding Below Was Correct

Texas law with respect to the nature of the interest created by an oil and gas lease and as the ownership of oil and gas in place, while furnishing cogent reasons for the applicability of the capital-gain sec-

[12] "The exemption of income devoted to charity *and the reduction of the tax on capital gains were liberalizations of the law in the taxpayer's favor*, were begotten from motives of public policy, and *are not to be narrowly construed.* (Emphasis supplied). *Helvering v. Bliss*, 293 U.S. 144-151.

tion (Section 117, I.R.C. 1939 p. 28 *infra*) to the transaction under consideration, is not controlling as to the applicability of this section to the present transaction. It is not necessary, in order to hold that the respondent's assignment resulted in gain taxable as long-term capital gain, to hold that this instrument conveyed real estate or oil and gas in place. This is true because Section 117 applies to all property—realty, personalty, tangible or intangible—except the types of property specifically excepted from its operation by the terms of that section. These exceptions include "real property used in his trade or business," but paragraph (j) of the section extends long-term capital-gain treatment to the profit derived from the sale or other disposition of "real property used in his trade or business" and held for six months or more, while providing that a loss from the disposition of such real property should be treated substantially as an ordinary loss. So it is wholly immaterial here whether the interest disposed of by P. G. Lake, Inc. be treated as the disposition of real property or of some other type of property, since we are concerned only with a gain and not with a loss.

It can hardly be argued that the transaction did not come within the literal terms of Section 117. There was a sale of property. The property sold had been held for more than six months. The oil and gas leases from which the oil payment came were by stipulation not held primarily for sale to customers in the ordinary course of the company's business. It is not suggested—and it is not the case—that P. G. Lake,

Inc. customarily sold oil payments; so that the capital gain principles governing a real estate subdivider are not applicable to this isolated transaction.

There can be but two reasons advanced for refusing to treat the transaction under consideration as the sale of a capital asset. One of these, and the one relied upon by the Commissioner in asserting the deficiency involved, is that the transaction was the anticipatory assignment of income.[1] The other, based primarily upon *Corn Products Refining Company v. Commissioner*, 350 U.S. 46, is that the transaction, while meeting the letter, is not within the spirit of the capital-gain section.

The "assignment of future income" theory disregards the essential nature of the transaction. The principle would be more accurately stated if instead of naming it "assignment of future income" it were denominated the "assignment of future income only, with retention of the income-producing property." No one will seriously contend that capital-gain treatment is to be denied in the sale of income-producing property merely because the future income from the property will go with the property to the buyer. This is true regardless of how certain is the amount of the future income and how quickly it may be realized by the purchaser of the property. So, since, regard-

[1] The transfer is incorrectly classed as "temporary" in the petition for certiorari, p. 11. The transfer was permanent. The interest transferred, because of its nature, was of limited duration.

less of State law, an oil and gas lease is everywhere recognized as property, the question is, whether there was an actual sale of an interest in the property.[*] Since the Commissioner cannot argue that the sale of an unlimited overriding royalty carved out of a leasehold interest is not a sale of property producing capital gain, he is forced to the position that an unlimited overriding royalty is an interest in the property, while a limited overriding royalty is not. There is absolutely no authority for such a position. It cannot be supported by State law, as the opinion below amply demonstrates; nor, so far as we have been able to ascertain, is there a single judicial determination supporting his position. In fact, since *Ortiz Oil Company v. Commissioner*, 102 F. 2d 508, all of the authorities have been to the contrary.

Nor does reason, apart from authority, support such a distinction. One acquiring an unlimited overriding royalty acquires no more control over the property than does one acquiring a limited overriding royalty or oil payment. Neither bears any share of the expense of operating and producing oil or gas. Each is valuable only because of the oil and gas applicable to the interest which will be produced. In either case, but for the carving out of the limited or unlimited overriding royalty interest, the oil and gas applicable to that interest when produced would have been the ordinary income of the assignor. The Commissioner does not make the actual duration of the interest the

[*] If there was such a sale, it, of course, carried with it the future income of the interest sold.

criterion. Thus, the sale of an unlimited overriding royalty carved out of a leasehold whose probable future life was, say, two years, would be treated by him as the sale of a capital asset, while the carving out of an oil payment which might run eight or ten years would be treated as an assignment of future income only. This is an indefensible position, and every court to which it has been presented has refused to adopt it.

It is difficult to see how the Commissioner can draw any comfort from *Corn Products Refining Company v. Commissioner*, 350 U.S. 46. The taxpayer's contention there was that its transactions in corn futures were separate and apart from its business of manufacturing products from corn. But in the year considered, the company's dealings in corn futures amounted to 14,595,000 bushels, and not only did the Tax Court and the Court of Appeals find that the company's dealings in futures were "an integral part of its business designed to protect its manufacturing operations against a price increase in its principal raw material and to assure a ready supply for future manufacturing requirements," but company officials testified that its dealings in corn futures were to fill an actual "need for the quantity of corn (bought) * * * in order to cover * * * what (products) we expected to market over a period of fifteen or eighteen months." Here was an extensive series of transactions, not only in the tax year but over a series of years, sufficient, entirely apart from the manufacturing business, of itself to constitute a business within the same rule that is applicable to the subdivision of real estate.

When considered in connection with the Company's manufacturing business it was nothing more than a part of the overall income from that day-to-day, year-to-year business. True, this Court said in the *Corn Products* case that Section 117 "must not be so broadly applied as to defeat rather than further the purpose of Congress," and that "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss."[15]

But the sale made by P. G. Lake, Inc. was not in "the everyday operation of a business." It was an isolated transaction, as would have been the sale of its entire interest in any of its oil and gas properties. This conforms with the statement made by this Court in the *Corn Products* case that, "The preferential treatment provided by Section 117 applies to transactions in property which are not the normal source of business income."

Burnet v. Harmel, 287 U.S. 103, and *Watson v. Commissioner*, 345 U.S. 544, are likewise inapplicable. In the *Harmel* case, the contention was that the granting of an ordinary oil and gas lease was a sale within the purview of the capital-gain section of the Revenue Act of 1921, because Texas law classified the transaction as a sale even though it was not elsewhere so classified. The holding was that because the taxing

[15] But this Court also held that the capital gain section is not to be narrowly construed. *Helvering v. Bliss*, 293 U.S. 144-151.

act should be given a uniform, nationwide application, the classification of a transaction as a sale under State law would not control in the absence of an express Congressional direction that State law be the criterion of applicability. Similarly, in the *Watson* case, the fact that State law regarded a growing crop prior to harvest as a part of the real estate did not, in the absence of a Congressional direction to that effect, require that the portion of the consideration received for the sale of the property, including the rapidly maturing crop, prevent that portion of the consideration allocable to the crop from being treated as property held by the taxpayer primarily for sale to customers in the ordinary course of trade or business and therefore excepted from the capital-gain section. It should be noted that in the *Watson* case this Court said:

> "We do not have here the situation which arises from the sale of land, including coal or other mineral wealth not separated from its natural state and not in the course of annual growth leading to a seasonal separation. * * * The instant case also is distinguishable from that of growing timber which is not in itself an annual or short-term product."

All that has heretofore been said as to the correctness of the result reached below is offered in amplification and not in derogation of the opinion below, which, we submit, fully supports and shows the correctness of the decision reached. We emphasize particularly what the Court below said upon the closely

related question of depletion. (pp. 81-82 petition for certiorari). An unavoidable result of the Commissioner's theory is a double allowance of depletion, contrary to *Helvering v. Twin Bell Oil Syndicate*, 293 U.S. 312. The Commissioner would allow it to P. G. Lake, Inc. (see p. 7 *supra*), and *G.C.M. 24849* recognizes that the one acquiring the oil payment is entitled to an allowance for depletion as he receives income therefrom. (See pp. 36-38 *infra*).

3.

The Requisite Conflict Is Not Present

The Commissioner asserts a direct conflict with the decision of the United States Court of Appeals for the Seventh Circuit in *Commissioner v. Slagter*, 238 F. 2d 901, and a conflict in principle with decisions of this Court. The decisions of this Court listed are *Burnet v. Harmel, supra; Corn Products Refining Company v. Commissioner, supra; Watson v. Commissioner, supra; Hort v. Commissioner*, 313 U.S. 28; *Harrison v. Schaffner*, 312 U.S. 579; *Helvering v. Clifford*, 309 U.S. 331; and *Commissioner v. Sunnen*, 333 U.S. 591.

We have heretofore dealth with the first three of the cases by this Court so listed. The Commissioner himself sufficiently distinguished the question dealt with in the other cases from that here involved when in *G.C.M. 24849* (Appendix, p. 39, *infra*) it was said:

> "The issue presented by such assignments of expected income between strangers in interest, presumptively at their present worth, should not be confused with the question presented in such cases as *Lucas v. Earl*, 281 U.S. 111; *Helvering v. Horst*, 311 U.S. 112; and *Helvering v. Eubank*, 311 U.S. 122, involving donative assignments of income by the earner thereof, in an attempt to divide his income between himself and members of his family. There the earner-assignor's attempt is to avoid realization of expected income. Here the assignor expedites such realization."

This quotation is all the more pertinent because it comes from the very ruling which provoked the present controversy.

The assertion of a direct conflict with the *Slagter* case as a basis for granting the writ applied for, is unusual in that the Commissioner repudiates that decision and would be the last to ask this Court to apply it to the case under consideration.

The facts in the *Slagter* case show that Slagter had been running oil produced from several leaseholds to Ashland Oil & Refining Company. Being in need of funds, he obtained $501,000 from Ashland and executed an instrument which entitled Ashland to 60% of his share of the oil thereafter to be produced, until it (Ashland) had received oil of the value of $513,000. Slagter also undertook in the selfsame transaction, to run his remaining 40% of the oil to Ashland and, to the extent he could control associated interests, to

cause these associated interests also to run and sell their oil to Ashland. There was no personal obligation on the part of Slagter to repay any part of the $501,000, Ashland agreeing to look only to the specified share of the oil for the recoupment of the money paid. The Commissioner treated the transaction as producing $501,000 of depletable ordinary income to Slagter when that amount of money was received by him. Slagter contended that this amount was the consideration received for an interest in his properties sold to Ashland, and, other statutory provisions being met, that he was entitled to have the resulting gain taxed as long-term capital gain. The Tax Court affirmed Slagter's position, but upon the Commissioner's petition for review, the Seventh Circuit Court held that the absence of a personal covenant or obligation to repay the money obtained from Ashland did not prevent the payment from being a loan from which Slagter received no income whatsoever but merely pledged 60% of his future production to the repayment of the loan. As applied to the *P. G. Lake, Inc.* case, since the transaction was consummated in 1950 (the tax year here involved) but the conveyance was effective at 7:00 a.m. January 1, 1951, the principle of the *Slagter* case would require a holding that P. G. Lake, Inc. received no income at all from this transaction in 1950 but is entitled to a refund of the capital-gain tax which it paid. This obviously is not the result which the Commissioner seeks to obtain from a review by this Court of the *Lake* case.

This analysis of the *Slagter* case throws light on the observation in the petition for certiorari (footnote 7, p. 13) that, "While we believe that the Seventh Circuit reached the correct result on the nature of the income, it reached a doubtful result on the question of when the income was realized." What the Seventh Circuit actually held as to the "nature of the income" was that there was no income received when Slagter received the $501,000, just as there would not have been had he given his promissory note to a bank for that amount secured by his oil properties. The further holding of the Court in *Slagter* was that when, after obtaining the money, oil was produced from the Slagter properties, the proceeds from this oil constituted his ordinary income from the properties involved. Under this theory, the difference between the $501,000 received by Slagter, and the $513,500 which Ashland was to receive and did receive, was a payment in the nature of interest.

We are not advised as to whether there is anything in Illinois law (in which state the Slagter properties were located) which induced the holding that an advance with no personal obligation to repay, made in consideration of the grant of an interest in property, is a loan,—but it is quite clear that the Commissioner's repudiation of the result reached in the Slagter case is not the first time that he has denied the applicability of the loan theory to such a transaction. In *Ortiz Oil Company v. Commissioner*, 37 B.T.A. 656, 102 F. 2d 508, cert. den. 308 U.S. 566, the taxpayer urged that a similar transaction was a loan, while the Commis-

sioner originally contended that it produced ordinary depletable income. The Board of Tax Appeals held that neither was right, but that the transaction was a sale of an interest in the property. When the case reached the Fifth Circuit, the Commissioner successfully defended the Board's holding, and this Court denied certiorari.

It may be fairly said that the *Slagter* case holds only that a somewhat similar transaction, with different and perhaps distinguishing features, is not a sale either of property or of "future income," but, under the peculiar circumstances, a loan. In no event can it be said that the *Slagter* case is a holding which the Commissioner of Internal Revenue will ask this Court to follow. This, we submit, is not the type of conflict which this Court had in mind in adopting its existing rules regarding the granting of a petition for certiorari.

CONCLUSION

For all of the foregoing reasons, it is respectfully submitted that the petition for certiorari should be denied.

Respectfully submitted,

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APPENDIX

Internal Revenue Code of 1939:

Sec. 117. Capital Gains and Losses.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23*(l)*, or real property used in his trade or business;

(C) a copyright; a literary, musical, or artistic composition; or similar property; held by—

(i) a taxpayer whose personal efforts created such property, or

(ii) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property; or

(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income:

(10) *Net capital gain.*—

* * * *

(A) Corporations.—In the case of a corporation, the term "net capital gain" means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges; and

(B) Other taxpayers.—In the case of a taxpayer other than a corporation, the term "net capital gain" means the excess of (i) the sum of the gains from sales or exchanges of capital assets, plus net income of the taxpayer or $1,000, whichever is smaller, over (ii) the losses from such sales or exchanges. For purposes of this subparagraph, net income shall be computed without regard to gains or losses from sales or exchanges of capital assets. If the tax is to be computed under Supplement T, "net income" as used in this subparagraph shall be read as "adjusted gross income."

* * * *

(c) *Alternative Taxes.*—

(1) *Corporations.*—If for any taxable year the net long-term capital gain of any corporation exceeds the net short-term capital loss, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 13, 14, 15, 204, 207(a)(1) or (3), 421 and 500, a tax deter-

mined as follows, if and only if such tax is less than the tax imposed by such sections:

(A) A partial tax shall first be computed upon the net income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted.

(B) There shall then be ascertained an amount equal to 25 per centum of such excess, except that in the case of any taxable year beginning after March 31, 1951, and before April 1, 1954, there shall be ascertained an amount equal to 26 per centum of such excess.

(C) The total tax shall be the partial tax computed under subparagraph (A) plus the amount computed under subparagraph (B).

(j) *Gains and Losses from Involuntary Conversion and from the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of property used in the trade or business.*—For the purpose of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23*(l)*, held for more than 6 months, and

real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in subsection (a)(1)(C). Such term also includes timber or coal with respect to which subsection (k)(1) or (2) is applicable and unharvested crops to which paragraph (3) is applicable. Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

* * * *

(2) *General rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power or imminence thereof) of property used in the trade or business and capital assets held for more than

6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsection (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

* * * *

(3) *Sale of land with unharvested crop.*—In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted as described in paragraph (2)) at the same time and to the same person, the crop shall be considered as "property used in the trade or business".

* * * *

Sec. 23(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if

the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. For percentage depletion allowable under this subsection, see section 114(b), (3) and (4).

* * * *

Sec. 114(b)(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

G.C.M. 24849

Consideration received for the assignment of a short-lived in-oil payment right carved out of any type of depletable interest in oil and gas in place is ordinary income subject to the depletion allowance where such consideration is not pledged for use in further development.

An opinion is requested with respect to the status, for Federal income tax purposes, of cash payments to owners of depletable economic interests in oil and gas in place as consideration for assignments of in-oil rights carved out of the economic interests held by them. Such rights entitle the assignee to oil or gas produced, or the proceeds derived from an agreed share of production if, as, and when produced, until a fixed or determinable amount of oil or gas, or an ascertainable sum of money, has been received. Such rights ordinarily pay out and expire within one or two years.

G.C.M. 22730 (C.B. 1941-1, 214) deals with the issue only to the extent of distinguishing the case in which an operator assigns an in-oil payment right in return for cash which he is pledged to use in the development of the property (in which event such cash payment is not income to the assignor and its use for the pledged purpose is not regarded as an expenditure by the assignor) from the instant case which involves

an outright purchase of an in-oil payment right for cash "wherein there is no such pledge to invest the proceeds in development and the buyer's capital investment would replace the lessee's capital investment allocable to the interest sold." This statement, made parenthetically in G.C.M. 22730, supra, at page 222, was not enlarged upon there. Consideration must now be given to the Federal income tax effect, in the case of the assignor, of a transaction wherein he receives unqualifiedly a cash payment for an in-oil payment right. Is such cash payment ordinary income or proceeds from the sale of a capital asset? If it is the latter, the capital gain is measured by the cash payment less the allocable part of the basis of the assignor-operator in the oil and gas in place, plus the estimated cost to him of producing the oil involved in the oil payment right—an obligation he assumes without further cost to the assignee.

G.C.M. 22730, supra, recognizes that the holder of an in-oil payment right, however acquired, has a depletable economic interest in the oil and gas in place, which is potentially a capital asset in his hands, provided the conditions of that classification under section 117 of the Internal Revenue Code are met. Such conclusions as to the status of the in-oil payment right in the hands of the grantee are not determinative of the nature of the transaction in the case of the grantor. As pointed out in the cited opinion, the controlling

decisions hold that a landowner who grants a lease, or a lessee who subleases or assigns his lease, in consideration of a cash bonus payment and an agreement to pay stipulated royalties is taxable on all such payments as ordinary income. In such a case, the cash bonus payment is regarded as an advance royalty payment subject to the depletion allowance as respects the lessor or sublessor, though it represents a capital investment by the lessee or sublessee in oil and gas in place, returnable tax-free to him by way of depletion deductions spread over the productive life of the lease asset in his hands. That conclusion rests on the analogy between the receipt of such advance royalty payments and substantial cash payments received by the lessor upon the execution of an ordinary lease, which payments are regarded as advance rental payments taxable as ordinary income. Thus, in connection with the instant issue, as in the cited opinion, the fact that the assignee acquires an asset which potentially qualifies as a capital asset in his hands does not require the conclusion that the assignor parted with such an asset.

In-oil payment rights, royalty rights, and operating rights are analogous in that they are essentially rights to production income characterized as ordinary income when realized. All are regarded as depletable economic interests in oil and gas in place entitling the owner to tax-free return of his investment through the depletion allowance. In-oil payment rights are distinguishable from royalty interests and operating

rights in that the latter interests, by definition, extend to the entire oil and gas resource content of the land, and, as such, represent forms of fractional property rights into which the property interests in oil and gas in place are commonly divided, whereas an in-oil payment right is a right to income for a limited time or amount. This difference is emphasized by the fact that an in-ol payment right may be carved out of either of the specified property interests in oil and gas in place, but the reverse is not true. Thus, sales of royalty rights or operating rights are sales of property rights, whereas assignments of in-oil payment rights carved out of such property rights, are, with respect to the assignor, essentially mere assignment of expected income from such property rights for a fixed or determinable period of time.

The issue presented by such assignments of expected strangers in interest, presumptively at their present worth, should not be confused with the question presented in such cases as *Lucas v. Earl* (281 U. S., 111), *Helvering v. Horst*, (311 U.S., 112, Ct. D. 1472, C.B. 1940-2, 206), and *Helvering v. Eubank* (311 U.S., 122, Ct. D. 1473, C.B. 1940-2, 209), involving donative assignments of income by the earner thereof in an attempt to divide his income between himself and members of his family. There the earner-assignor's attempt is to avoid realization of expected income. Here the assignor expedites such realization. See *Herman M. Rhodes v. Commissioner* (43 B.T.A., 780, affirmed, 131 Fed. (2d) 50), wherein the United States Board of Tax Appeals (now The Tax Court of

the United States) held that a stockholder's "exercise of his power to sell or assign his right to receive the declared dividend constituted a realization of income by petitioner (stockholder) taxable to him as ordinary income."

In principle the assignment of a right to a dividend seems indistinguishable from assignments of other rights to expected income. Assignments of income rights by the earner for cash or property, measured by the then worth of such rights, may not be disregarded, and as respects such earner-assignor, he has elected to anticipate normal realization by assigning or discounting such right. Consideration received by him represents ordinary income realized by him upon the anticipatory assignment of his right to income. Once such rights to income from property or for services are separated from the earner by his act of assignment, they become property rights owned by the purchaser or assignee with a basis in his hands measured by the consideration paid. Thus, any discounting of the face value of the income right or claim by the earner thereof upon the assignment will result in income to the assignee when such discount is realized by him.

The stated general rule with respect to anticipatory assignments of income for cash or property seems equally applicable to assignments of income arising from royalty or operating property rights in oil and

gas in place. As noted above, the characterization of a transaction as a purchase in the case of the assignee is not inconsistent with treating it as a mere anticipatory realization of ordinary income to the earner. That is true under the general rule pertaining to such assignments as well as to cases of grants of depletable interests in oil and gas in place for advance royalty payments made to obtain such grants under oil and gas leases. Similarly, it is immaterial that the assignment of income vests a depletable right in the assignee. The right to depletion, as such, is not transferred. The assignor, on receipt of the anticipated income thereby realized, is entitled to the depletion allowance which is designed to compensate him for the diminution in his interests sustained by the conversion of capital into ordinary income thereby affected. Thus, qualification of the assigned right as a depletable right in the hands of the assignee springs from the character of the right rather than from the transfer. To the extent that there is a shift of depletable interest, it is analogous to the corresponding shift resulting from a cash bonus or an advance royalty payment made to obtain an oil and gas lease. In both instances, the assignor or grantor is entitled to a depletion allowance which attends the income thereby realized by him, and the assignee, in both instances, acquires a depletable economic interest in oil and gas in place.

For the reasons stated, it is the opinion of this office that consideration (not pledged for development)

received for the assignment of a short-lived in-oil payment right carved out of any type of depletable interest in oil and gas in place (including a larger in-oil payment right) is ordinary income subject to the depletion allowance in the assignor's hands. No opinion is expressed with respect to the status of in-oil payment rights extending over a substantial portion of the life of the depletable economic interests from which such rights are carved.

J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue

I.T. 4003

Assignments of in-oil payment rights

Advice has been requested with respect to the phrase "short-lived in-oil payment rights," as used in G.C.M. 24849 (C.B. 1946-1, 66) and I.T. 3935 (C.B. 1949-1, 39).

G.C.M. 24849, supra, expresses the opinion that consideration received for the assignment of a short-lived in-oil payment right carved out of any type of depletable interest in oil and gas in place is ordinary income to the assignor unless such consideration is pledged for use in further development. As a precaution, pending further consideration of the feasi-

bility of distinguishing between short-lived and long-lived in-oil payment rights, the statement was made in G.C.M. 24849 that: "No opinion is expressed with respect to the status of in-oil payment rights extending over a substantial portion of the life of the depletable economic interests from which such rights are carved."

After careful study and considerable experience with the application of G.C.M. 24849, supra, it is now concluded that there is no legal or practical basis for distinguishing between short-lived and long-lived in-oil payment rights. It is, therefore, the present position of the Bureau that the assignment of any in-oil payment right (not pledged for development), which extends over a period less than the life of the depletable property interest from which it is carved, is essentially the assignment of expected income from such property interest. Therefore, the assignment for a consideration of any such in-oil payment right results in the receipt of ordinary income by the assignor which is taxable to him when received or accrued, depending upon the method of accounting employed by him. Where the assignment of the in-oil payment right is donative, the transaction is considered as an assignment of future income which is taxable to the donor at such time as the income from the assigned payment right arises.

Notwithstanding the foregoing, G.C.M. 24849, *supra*, and I.T. 3935, *supra*, do not apply where the assigned in-oil payment right constitutes the entire depletable interest of the assignor in the property or a fraction extending over the entire life of the property.

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No. [redacted]

In the

Supreme Court of the United States

FRANK SCOFIELD, Former Collector of Internal Revenue,
Petitioner,

v.

DENNIS M. O'CONNOR and KATHERINE O'CONNOR, Independent Executors of the Estate of THOMAS O'CONNOR, Deceased, and DENNIS M. O'CONNOR, KATHERINE O'CONNOR, MARY O'CONNOR BRAMAN, Joined by her Husband, D. H. BRAMAN, and THOMAS O'CONNOR, JR.,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR RESPONDENTS IN OPPOSITION

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BRIEF FOR RESPONDENTS IN OPPOSITION

STATEMENT

The question in this case is whether the cash sale for the sum of $9,990,350 of a limited overriding royalty is subject to capital gain treatment under Sec. 117 of the 1939 Revenue Code where, as found by the Courts below, the sale was bona fide; had a bona fide business purpose; was not a loan or mortgage; was not an assignment or anticipation of income but was a sale of a real and substantial interest in the taxpayers' properties.

On Nov. 26, 1948 the Executors of the Estate of Thomas O'Connor, deceased, transferred, by general warranty deed, duly recorded in the deed records of Refugio County, Texas, the entire royalty interest of the Estate under eight designated tracts of land to one D. E. Blackburn for the cash consideration of $9,990,350. The royalty interest sold to Blackburn had been held by decedent and subsequently by his Estate for many years. (R. 69.) The deed provided that after the royalties described therein had produced for Blackburn the prescribed quantity of oil, the properties would revert to the grantors. (R. 69-70.) Blackburn made a substantial profit on the transaction and reported and paid tax on his profit. (R. 70.)

The sale was made for the purpose of raising funds to pay Federal estate taxes, State inheritance taxes, Federal income taxes and administration expenses of the Estate. (R. 47.)

This was the first and only sale of any type of mineral interests that the decendent or his Estate had ever made. (R.71.)

The oil payment "paid out" after three years of production and while the royalties were owned by Blackburn. The oil payment would have taken an appreciably longer period to pay out had it not been for the fact that there was an increase in the production in the field because of the drilling of additional wells by the operating lessees and had it not been for the further fact that there had been a substantial increase in the price of oil shortly prior to the

sale of the oil payment, which higher price was maintained during the period of the pay-out. (R. 71.)

If the sale is entitled to capital gain treatment, the tax on the sale is a little over $2,000,000. If, however, the proceeds are taxable as ordinary income, the tax, after allowance for depletion, will amount to over $5,600,000.

Based on a stipulation of facts and the uncontradicted testimony of two witnesses, the District Court made the following findings:

Both the sellers and the buyer, Blackburn, intended the transaction in question to be a sale and purchase of the royalty interest in question. They did not intend to enter into a loan or mortgage transaction. (R. 70.)

The transaction with Blackburn was a bona fide sale. (R.72.)

The purpose of the sale was a bona fide business purpose. (R. 70.)

The transaction was not intended to be and was not, as a matter of fact or a matter of law, an assignment of income, but was the sale of a property interest to Blackburn, which property interest produced income in the hands of Blackburn. (R. 72.)

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[1]The basis of the property sold is stipulated to be approximately $2,000,000. The selling price was approximately $10,000,000. Thus, the gain was about $8,000,000; and the capital gain tax, at 25%, was about $2,000,000. Since the sale was made to raise funds to pay very heavy estate taxes, the taxpayers feel that the Government should be content with the $2,000,000 capital gain tax and that the higher tax at normal rates should not be exacted unless plainly required by the Statute.

This property interest was substantial and real, representing a substantial part of the grantors' royalty interest. (R.72.)

The property so sold was a long-lived, and not a short-lived, oil payment. (R. 72.)

The property interest so sold to Blackburn was a capital asset as defined in Sec. 117 of the Internal Revenue Code of 1939, and this capital asset had been held by taxpayers for more than six months. (R. 72.)

The Circuit Court of Appeals, after reviewing the evidence, held that "on record made, the District Judge was right and his judgment should be affirmed."

ARGUMENT

The petition should be denied because the decision below was right; there is no conflict; and no important question affecting the revenues is presented.

Prior to 1946, the Treasury Department consistently recognized that the sale of an oil payment was the sale of capital asset under Sec. 117 of the 1939 Code. In 1946, observing that short-lived oil payments "ordinarily pay out and expire within one or two years," it was ruled that such "short-lived" oil payments, as distinguished from one "extending over a substantial portion of the depletable economic interest from which such rights are carved," should be treated as an anticipation of income and taxed

at ordinary rates. *G. C. M. 24849 (1946-1 C. B. Page 66.)*[2]

In 1950, the Treasury Department changed its position, holding that no distinction should be made between a short-lived and a long-lived oil payment and that all sales of oil payments carved out of a larger interest, irrespective of life, should be taxed at ordinary rates. *I. T. 4003, 1950-1 C. B., Page 10.*

In the *Caldwell* case, the Fifth Circuit refused to follow this later I. T., holding that sales of oil payments carved out of royalty interests and having lives of from nine to 13 years were sales of capital assets under Sec. 117. The Government did not seek certiorari in that case.

Later, the Fifth Circuit decided the *Hawn* case.[4] There, the taxpayer assigned an oil payment out of a larger one to a contractor to help finance the construction of a home. The oil payment so assigned had a life of 19 months and in the contract with the contractor, the taxpayer guaranteed the rate of interest on loans which the contractor expected to make from local banks to finance the construction and the contractor agreed to return to taxpayer part of the oil payment proceeds in event the interest on such bank loans was less than anticipated. Under the facts and considering the insubstantial nature of the oil payment, the Court held that no sale of a capital asset was made and that the tax-

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[2]The sale in question was made while this ruling was in effect and the District Court found that the oil payment in question was a long-lived one and involved a substantial part of the taxpayer's royalty.

[3]*Caldwell v. Campbell, 218 F. 2d 567 (C. C. A.-5, 1955).*

[4]*Commissioner v. Hawn, 231 F. 2d 340 (1956).*

payer would not be taxed on the proceeds from the so called "sale" but should remain taxable in the future on the sale of production attributable to the assigned oil payment.

In the cases now before the Court, the District and the Tax Court followed the *Caldwell* case and held that the taxpayers had sold capital assets. On appeal to the Fifth Circuit, the Government admitted that the *Caldwell* case was right and therefore that the extreme position taken in its 1950 ruling was wrong. The Government also agreed that where the sale, as here, was out of a royalty interest, the taxpayers had not sold income but had sold a part of their investment property. However, it contended that the Court should draw an arbitrary line between a substantial and an insubstantial oil payment, urging that the line should be drawn at a nine-year pay-out. The Fifth Circuit, refusing to draw such an arbitrary line, held that if such a line were to be drawn, it should be drawn by Congress, and not by the courts. The Court reaffirmed its earlier decision that as a general rule the sale of an oil payment, if a bona fide sale, is the sale of a capital asset entitling the taxpayer to capital gain treatment under Sec. 117. However, the Court recognized that not every sale of an oil payment would support capital gain treatment. It recognized that "The Court in each case takes all of the facts into consideration for the purpose of determining, whether as a matter of law, a transaction was or was not a sale of capital assets, so as to entitle it to capital gain treatment under Sec. 117." The Court recognized that in any "devious" transaction, as illustrated in the case of *Rudco Oil and Gas Company v. U. S., 82 Fed. Supp. 746 (Ct. Cls., 1949),*

capital gain treatment would be denied. Likewise, the Court recognized that if a sale was essentially the sale of current production, this Court's decision in *Burnet v. Harmel, 287 U.S. 103 (1932)*, would apply and the transaction, though in form a sale of property, would be taxed at ordinary rates. In addition, it recognized that if the transaction was merely "the normal source of business income," the decision of this Court in *Corn Products Co. v. Commissioner, 350 U. S. 46, 52 (1955)*, would apply and the transaction would be taxed at ordinary rates.

1. It is respectfully submitted that the decision below was right; in fact, it was the only decision that the Court could render under existing statutes.

The sale in question was a sale of a large part of taxpayers' investment property. It was a sale of "property" as that term is used in Sec. 117 and is thus within the letter of the capital gain provisions. In Texas and elsewhere, an oil payment is real property; it is in the nature of a limited overriding royalty; it descends on death as real and not personal property; it is subject to laws governing the conveyancing of real property, to ad valorem taxes on land, to recordation statutes affecting land; and in every respect is a real property interest,[5] subject to federal stamp taxes applicable to real estate sales. That such an interest is "property" is likewise recognized by the decisions of this Court.[6] Since it is "property" as that term is used in Sec.

[5] *Tennant v. Dunn, et al., 110 S. W. 2d 53 (Comm. of App.); State v. Whittenburg, 265 S. W. 2d 569; State v. Quintana Petroleum Co., 143 S. W. 2d 112 (opinion adopted by the Supreme Court, 134 S. W. 2d 1016).*

[6] *Thomas v. Perkins, 301 U. S. 655; Anderson v. Helvering, 310 U. S. 404.*

117(a), it is within the letter of Sec. 117(a) of the Code, and a sale thereof entitles the seller to capital gain treatment, since the transaction does not fall within any one of the enumerated exceptions outlined in the statute.

The sale in question was also within the spirit and purpose of Sec. 117 as well as its letter. The purpose of Sec. 117, as stated by this Court in *Burnet v. Harmel*, supra, was "to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions." In holding that the recurring, day to day, sales of oil were not the type of property sales which Congress had in mind in adopting the capital gains provisions, the Court, in *Burnet v. Harmel*, supra, said:

> "* * * But notwithstanding this incidental transfer of ownership, it is evident that the taxation of the receipts of the lessor as income *does not ordinarily* produce the kind of hardship aimed at by the capital gains provision of the taxing act * * *. [T]heir abstraction from the soil is a *time-consuming operation* and the payments made by lessee to lessor do not *normally* become payable as the result of a *single* transaction within the taxable year, as in the case of a sale of property * * *.
>
> "* * * Such operations * * * have been said to resemble a manufacturing business * * *." (Emphasis added.)

The sale in this case was the sale of real estate, and not, as in the case of the daily production, a sale of personalty.

It was a sale of a large quantity of oil in place which was, and remained, real property. It was not the day to day recurring conversion of realty into personalty. It did not involve the time-consuming operations involved in daily sales. There was nothing in this sale that slightly resembled a manufacturing process. The sale was "a single transaction within the taxable year as in the case of the sale of property." It thus fell within the spirit and purpose of Sec. 117, which was "adopted to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments." To tax the gain on such a sale as normal income would "produce the kind of hardship aimed at by the capital gains provisions" since it would "bunch" in a single year and tax at surtax rates graduated up to 91%, not just six months of profits, but profits of a number of years. Thus, the sale in question fell within both the spirit and purpose, as well as the letter, of Sec. 117, and, since the sale was bona fide, was not a device, did not arise in the normal course of business operations, was not a sale of current production, but was a sale of a substantial part of the taxpayer's royalty, the Court correctly found that the taxpayer was entitled to capital gain treatment.

2. There is no conflict. The Government in its petition retracts the admission made below that the *Caldwell* case was right and now contends that every oil payment sale, no matter how large or how long in duration, is to be denied capital gain treatment. No court has accepted this position. Some 25 judges have considered the Government's

proposal and, without exception, all of these judges have refused to adopt it. The proposal has been considered by the Tax Court on a number of occasions, and its decision has been reviewed by the entire Board of 16 Judges. The question has also been considered by the District Court in this case and by the Fifth Circuit on three occasions by different judges (in addition to these four cases, see *Caldwell v. Campbell*, supra; *Commissioner v. Hawn*, supra) and it has been considered by the Seventh Circuit in the *Slagter* case.[7] None of these judges accepted the Government's position.

The *Slagter* case, relied on by the Government for conflict, is clearly not in conflict. In the *Slagter* case, the transaction was with the pipe line company which had been purchasing the taxpayer's daily production. The Court held that the transaction was not a sale at all, but was a loan transaction, the taxpayer simply assigning his oil runs to secure the loan. Since there was no sale, it held that no tax at all was due on the cash payment received by the taxpayer in the year of the transaction. It held that the taxpayer should remain taxable on the monies received by the transferee in repayment of the loan. Thus, the Court did *not* hold, as the Government would represent, that the cash received in the transaction should be taxed at ordinary rates. It held that this receipt was not taxable at all. It held that other monies received in later years in repayment of the loan was to be taxed in such later years to the assignor. Very clearly, the Court, in holding that there

[7] *Slagter v. Commissioner*, 238 F. 2d 901 (1956).

was no sale, did not reach the question presented here, of whether the cash received on a true sale is to be taxed at ordinary or capital gain rates. The Court below distinguished the *Slagter* case on these differences in fact and result. The Government in its petition disagrees with the holding in the *Slagter* as well as in these cases. Moreover, the Government, though losing the *Slagter* case, did not see fit to ask for certiorari in that case, although it had ample time to do so following the decision in these cases. Apparently the Solicitor General, in deciding not to apply for a writ in *Slagter*, did not then feel there was a conflict.

The "assignment of income" cases relied on by the Government (*Helvering v. Horst*, 311 U. S. 112; *Helvering v. Clifford*, 309 U. S. 331; *Harrison v. Schaffner*, 312 U. S. 579; *Helvering v. Eubank*, 311 U. S. 122) are likewise inapposite. Those cases all dealt with the economic questions of what is income under Sec. 22(a) and who was to be taxed on such income. They all dealt with gifts of income from one member of a family to another member where the donor retained the corpus that produced the income in question. None of the cases involved a *sale* to a stranger, and none of them involved the question of the applicability of Sec. 117 to a sale. Those cases dealt simply with the question of *who* among the family members was to be taxed on income where the donor retained the income-producing property. None of them dealt with the utterly different question of *how*, and *at what rates*, a true sale of a property interest should be taxed. Moreover, those cases dealt with income in the nature of interest, dividends and rents

which were "derived from" capital; income which was separated from the producing corpus and given away; the corpus remaining intact, capable of producing additional income in future years. The sale of the oil payment in this case was not a sale of income separated from or "derived from" a non-depleting corpus. It was not the sale of the fruits from the tree; but rather the sale of a part of the tree itself; it was the sale of a part of the oil reserves in place. That which was sold was itself a separate corpus; the part retained, represented by the reversionary interest, was not a corpus producing that which was sold. The retained interest and the interest that was sold were separate and different parts of the taxpayer's investment property.

3. No question of great importance affecting the revenues is presented. The Government, in its petition, complaining of what it terms "temporary" transfers, retracts the admission made below that the *Caldwell* case was rightly decided and now takes the position that every sale of an oil payment, no matter how long its life or how large it be, should be treated as an assignment of income and taxed at ordinary rates. It says that unless this extreme position is adopted, that there will be a "widespread usage" in the oil industry of oil payments "as a device to turn ordinary income into capital gain." It states, on the matter of importance, that at the present time, "* * * this issue is involved in 43 docketed and undocketed cases which, of themselves, represent an estimated loss to the revenue of many millions of dollars if the transferors are held to have

realized capital gain rather than ordinary income." It is respectfully submitted that the Government over-states the importance of the matter.

The extreme position now taken by the Government is untenable. Its position is that if a taxpayer, owning only an oil payment having an expected life of two years, sells such oil payment, he has sold a capital asset and is entitled to capital gain, but if he sells an oil payment out of a larger interest he has ordinary income even though the oil payment so sold has a life of 13 or even 20 years. If he sells an entire oil payment representing 1,000 barrels of oil he has capital gain; but if he sells one involving a million barrels in place he has ordinary income if he retains a reversionary interest of so much as a single barrel. *I. T. 4003*, supra. If he sells an oil payment with a possibility of reverter after the oil payment pays out and the oil payment does not in fact pay out (because of a mistake in estimating reserves, reduced gas pressure, salt water encroachment, price decline, or some other cause), he has ordinary income, but if he sells exactly the same oil without a possibility of reverter, he has capital gain. As shown above, this view is unsound and is contrary to the letter and purpose of Sec. 117. No court has accepted such an extreme view. Prior to 1950, the Treasury rule was to the contrary; its first published ruling was to the contrary. *G. C. M. 24849*, supra. The admission below that the *Caldwell* case was right and the failure to apply for certiorari in that case indicate the Government's uncertainty as to the correctness

of this extreme position. If such a rule is deemed desirable Congress and not the courts should be asked to write another exception into the capital gain provisions of the law.

Nor is this extreme position necessary to the protection of the revenues. The Court below recognized that not every sale of an oil payment would entitle the transferor to capital gain treatment. As the Court below observed, the lower courts will examine the facts in each particular case to determine whether Sec. 117 applies. If the transaction is not a true sale, but in essence, a loan transaction, or is otherwise lacking in bona fides, the courts may, as in the *Haire* case, ignore the transaction and tax the transferor on the income when and as received by the transferee. Moreover, the Court below recognized that if the transaction is a mere "device to turn ordinary income into capital gain" the Courts will be quick to deny capital gain treatment. And if the transaction is essentially a sale of current production, this Court's decision in *Harmel* will be applied. Likewise, if the sale arises in the normal course of business operations, this Court's decision in the *Corn Products* case will be applied and capital gain treatment denied.

It is submitted that the pending 43 cases can be handled administratively or by lower courts within the framework of these settled principles and in accordance with the facts of each particular case. If it be said that these rules will result in some taxpayers receiving capital gain treatment and that the seller of an oil payment having a three, five, or ten year life should not have this treatment, the answer

is that Congress intended to "relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investment" (*Harmel v. Commissioner*, supra). If a change in this policy be sought, recourse should be to the Congress and not the courts.

Thus, to give this case even a tinge of importance, the Government has been forced to repudiate the position it took below that *Caldwell* and *Hawn* were correctly decided and to take the new position that *all* oil payment sales result in ordinary income. To do so is to urge this Court to legislate in much the same way it would have to legislate, were the Government to ask the Court to decide, for example, that gain from *all* sales of real estate were ordinary income since *some* persons had been accorded capital gain treatment on land sales and, as a result, many docketed and undocketed cases involving many millions of dollars were pending.

The cases are essentially fact cases,—run of the mill tax cases which were decided under established principles. If numbers of situations or dollar amounts were the criterion for granting certiorari, then this Court would hear nothing but real estate dealer cases (and decide whether the gain on sale was a capital gain or ordinary income) and family partnership cases (and review the findings of fact after a lower court has made its determination).

Here, as shown in the Statement, the lower Court has made the essential fact findings establishing this Estate's right to capital gain treatment.

CONCLUSION

Under well established principles governing the granting of certiorari, this Court will not review decisions of the lower courts, which are clearly not in conflict, which clearly apply correct principles of law, and which present no element of confusion on the part of the lower courts.

Under well established rules governinng the granting of certiorari, it is not enough for the Government simply to allege that the decided case involves loss of revenue to the Government. In any case where capital gains treatment is allowed, loss of revenue occurs. The capital gains provisions were enacted by Congress to give relief from ordinary rates in many situations deemed by Congress to merit such relief.

Nor is it enough to establish the right of review, for the Government to allege that the situation requires clarification by this Court because of pending cases. The confusion in this field is with the Government and not the courts. As pointed out above, the Government has vacillated in its position, beginning prior to 1946 when sales such as here involved were not questioned by the Government. This confusion on the part of the Government continued through the preservation of the Government's position in these cases in the lower courts where it admitted that the *Caldwell* case was correctly decided; and now the confusion continues in its petition for certiorari wherein it argues that no oil payment sale is entitled to capital gains treatment. Admittedly the Government's position throughout the history of the cases involving this question has been marked

by lack of clarity and by confusion. But this confusion has not affected the decisions of the lower courts which have consistently applied the correct principles in this area.

Thus, we submit that the Government position in its petition comes down to this: We do not like the results reached in these cases; a contrary result would mean a gain in revenue to the Government; a complete reversal of the decisions in these cases will relieve the Government of its responsibility to decide cases in this field on the basis of the particular facts in each case.

We, of course, can understand why the Government would be pleased with a reversal of these decisions, but we submit that the granting of certiorari in this case would not subserve any useful purpose and that this case is not of such importance as to warrant review by this Court. We therefore respectfully submit that the Petition for certiorari should be denied.

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In the

Supreme Court of the United States

OCTOBER TERM, 1956

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

JOHN WRATHER AND NELL WRATHER, Husband and Wife,
Respondents.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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This case is one of five[1] in which the Government has petitioned for Writs of Certiorari to the United States Court of Appeals for the Fifth Circuit complaining of that Court's judgment that these sales of oil payments are entitled to capital gain treatment under Section 117 of the Internal Revenue Code of 1939. The Government invites favorable consideration by this Court on the grounds

[1]The other four cases are *Lake*, *O'Conner*, *Fleming* and *Weed*.

that the decision below is erroneous, that the decision is in direct conflict with the decision of the Seventh Circuit in *Commissioner v. Slagter (238 F. 2d 901)*, and that questions are presented which are of importance in the administration of the revenue laws.

THE JUDGMENT OF THE FIFTH CIRCUIT IS CORRECT

The petition in this case should be denied because the Court below has reached the correct conclusion. The decision entered results from the application of certain fundamental principles derived from decisions of this Court defining the income tax nature of oil and gas transactions, particularly with respect to oil payments.

Oil payments are created either by transferring a larger oil interest and reserving an oil payment or by carving out an oil payment from a larger oil interest and transferring it to another. In either case the nature of the interest created is precisely the same. In both cases the oil payment is an economic interest in the oil and gas in place entitling the owner to an allowance for depletion on proceeds derived from the sale of production attributable to the oil payment. The reference in the Petition (p. 9) to an "Oil Payment Agreement" in this case can be misleading since it is well established that if the owner of an oil payment must look solely to the oil in place to realize on his investment, there is a true oil payment regardless of the

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[2] *Palmer v. Bender, 287 U. S. 551; Thomas v. Perkins, 301 U. S. 655; Anderson v. Helvering, 310 U. S. 404; Burnet v. Harmel, 287 U. S. 103.*

form of the conveyance. That an oil payment is "property" would seem to be beyond further argument. The Government does not contend, and never has, that the sale or exchange of other kinds of interests in oil and gas in place[3] results in the realization of ordinary *depletable* income. Just one class of such property has been singled out for this treatment—the carved-out oil payment. Nor is this distinction to be attributed to one or more of the exceptions to the transactions qualifying for capital gain treatment under the provisions of Section 117 of the 1939 Code. In short, it may not seriously be contended that the oil payment sales in this case do not fit the express terms qualifying the gains therefrom as long-term capital gains.

The *non sequitur* is circumnavigated by announcing that the sales in the instant case were in reality not "sales" of "property" at all but were merely anticipatory assignments of income. After many years of the opposite view, the Government reversed its position in 1946, publishing GCM 24849, 1946-1 CB 66, maintaining that thereafter oil payments carved-out and sold which require only one or two years to "pay-out"[4] would be treated as if they were anticipatory assignments of income and the consideration taxed as ordinary income subject to the depletion allowance. In 1950, this view was expanded in IT 4003, 1950-1 CB 10, to encompass all such sales regardless of the length of the pay-out. It cannot be gainsaid that this action was

[3] E. g., oil and gas leasehold or working interests, royalties and overriding royalties.

[4] The expression "pay-out" normally refers to the period of time required for sufficient oil and gas attributable to the oil payment interest owned to be extracted from the ground and sold.

taken without legislative or judicial suggestion or sanction. The Government alleges (Pet. for Cert., p. 20) that taxpayers generally accepted the position set forth in the above rulings. If it were not enough to say that these erroneous legal opinions may not be given the force of law through passive acquiescence of some taxpayers, it need only be pointed out that it has been the subject of controversy since its inception as is exemplified in no small part by these five cases. However, it is noteworthy that the sales here involved were made in 1948, at a time when by the Government's own ruling (GCM 24849, supra) this taxpayer could expect no controversy over capital gain treatment.

The history of the Government's vacillations on this point certainly indicates a recognization of the lack of legal means for adopting the rule presently advocated otherwise than by congressional action. It is submitted that this Court should judiciously refrain from taking legislative action in this case.

This Court's decisions in *Burnet v. Harmel (287 U. S. 103)*, and more recently in *Corn Products Co. v. Commissioner (350 U. S. 46)*, are pointed to as supporting the Government's theory that the oil payment assignment in this case may not be afforded the preferential capital gains treatment. Of course, both the *Harmel* and *Corn Products* cases involved factual situations not even remotely similar to this case. In the *Harmel* case it was held that where upon an assignment of an oil and gas lease the assignor

received a cash bonus and retained a royalty interest, no sale was made. Without a sale or exchange the capital gains provisions manifestly did not apply. In *Corn Products*, the taxpayer engaged in hedging transaction in corn futures. It was found unequivocally that the transactions involved were an integral part of the taxpayer's business designed to protect its manufacturing operations. Such transactions are inherently not capital gains transactions. They are the regular, daily business dealings of the taxpayer and are not the isolated, non-recurring conversion of capital assets represented by the sales in this case.

Justice Stone, in *Burnet v. Harmel*, supra, observed that the capital gains provisions (p. 106):

> "* * * were adopted to relieve the taxpayer from these excessive burdens [referring to high sur-tax rates] on gains resulting from a conversion of capital investments, and to remove the deterent effect of those burdens on such conversions."

Oil and gas property interests are peculiar in that the interest owned is a wasting asset which, on the one hand, is the income-producing asset and on the other, when consumed by extraction and production, becomes the income itself. The pertinence of this proposition lies in the fact that the tax results vary according to the method adopted by the interest owner of realizing on his capital investment therein. Two methods are available: The oil may be extracted from the ground and sold, thereby producing ordinary depletable income, or all or part of the interest owned in the oil and gas in place may be sold or exchanged, there-

by producing capital gains. In the instant case the taxpayer adopted the latter method of realizing upon his investment in the oil and gas in place. The Government is asking that this Court ignore the realities of the transaction and to bunch into a single year to be taxed at high surtax rates income from the production and sale of oil which would otherwise have been taxed over a period of five years.

It is interesting to consider that had the instant taxpayer continued to produce the oil from the leases here involved over the five-year period, taking 27½ per cent depletion thereon, whether or not a greater tax would have been due in the aggregate at ordinary income tax rates than is found to be due as capital gain tax. Actually subjecting the facts in this case to that test by prorating the consideration received on the sale of the oil payments over the five-year period and allowing the depletion deduction, but assuming no other income in each year, the total income tax due is substantially the same as the capital gains tax. Of course, in such a case it might be said that this ordinary income would fall on top of the taxpayer's other income and be taxed at higher rates. It is well known, however, that for men who are actively engaged in exploring for and developing new oil fields, tax losses are sustained which in this case might even have eliminated entirely the income tax on that production. Thus it will not do to say that the

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Unless, of course, the seller is in the business of selling such interests on a regular basis so as to fall within one of the exceptions to the definition of capital gains transactions in Section 117, 1939 Code. This is not the case here as it was stipulated otherwise. (R. 40.)

tax must be collected now at ordinary rates because if the taxpayer had not sold the oil payment he would have paid tax at ordinary rates over the pay-out period.

NO CONFLICT OF DECISIONS

The Government's contention that there is a conflict between the decision below and that of the Seventh Circuit in *Commissioner v. Slagter (238 F. 2d 901)*, is without foundation. It is submitted that the views of the Fifth Circuit and Seventh Circuit are rather perfectly in harmony as will be noted when comparing the decision in *Slagter* with that of the Fifth Circuit in *Commissioner v. Hawn (231 F. 2d 340)*. In both cases each Court concluded from the facts that no *sale* of an oil payment was made but rather that the transactions amounted to loans which were to be repaid to the lenders from the oil payment assigned for that purpose. Therefore, the money received by the assignors was not taxable at all when received but rather it was held that the assignors were taxable on the proceeds of the production attributable to the oil payment as and when received by the assignees in repayment of the advances. This is not the result which was contended for by the Government in either *Slagter* or *Hawn*, nor for that matter in the instant case. It must be recognized that both the Seventh and the Fifth Circuits agree that where from the facts presented, it is plain that no *sale* of an oil payment was accomplished but rather there was a loan transaction, that the proceeds of the loan are not taxable at all.

This being true, neither Court reached the question that if a sale was accomplished, how was the gain to be taxed.

This was the law of the *Slagter* case and while it was contrary to the Government's contentions no petition for certiorari was filed despite the fact that time still remained in which to file such a petition after the decision in this case was handed down by the Fifth Circuit. It appears then that the Government is merely seeking to take an appeal from the adverse decision in the instant case while allowing the time in which to *appeal* in the *Slagter* case to expire.

The Government vigorously argues that the instant case is indistinquishable from the *Slagter* case, notwithstanding the fact that in *Slagter* the assignee of the oil payment, a refinery, had been purchasing the oil from the very same properties all along and was quite anxious to continue to have a call on that oil as well as all the other production of the taxpayer which was available. This fact induced the assignee to make advances to the taxpayer, in the nature of a loan, receiving repayment out of the assigned oil interest. In the instant case the taxpayer and the assignee were wholly unrelated and a loan transaction was in no sense consummated. On the facts, the Court below concluded that a sale had been accomplished.

The Government asserts that the decision below conflicts with certain decisions of this Court concerning the tax results of donative assignments of income.[6] But clearly,

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[6] *Helvering v. Horst, 311 U. S. 112; Helvering v. Clifford, 309 U. S. 331; Harrison v. Schaffner, 312 U. S. 579; Hort v. Commissioner, 313 U. S. 28;* and *Commissioner v. Sunnen, 333 U. S. 591.*

the question here was not presented in those cases, as there, this Court thwarted the taxpayers' attempts to avoid altogether, taxation to themselves of income, in most cases already earned, by transferring the right to receive that income to another.

It is therefore, submitted that no conflict of the decision below with decisions in other circuits or with decisions of this Court exists.

IMPORTANCE OF THE QUESTION

There is no important reason why this Court should feel compelled to review the decision in this case. The lower courts have demonstrated a capacity to dispose of those cases whose facts indicate a lack of substance in a transaction alleged to be a sale, and have done so without doing violence to, or without amending judically, Section 117 of the Internal Revenue Code of 1939. Just as in other areas of Federal income taxation, the courts below, following the teachings of this Court, are indisposed to permit mere form to prevail over substance. In so doing the tax consequences of carved-out oil payments have been construed in such a way as to avoid unwarranted capital gain treatment. It is firmly believed that the "43 docketed and undocketed cases" (Pet. for Cert., p. 21) will be disposed of administratively and judicially without the "loss" of revenue anticipated in the petition.

Moreover, "device" cases may also be expected to run afoul of the refusal judicially to approve employment of

devious means to divert income from the earner thereof to another or to convert ordinary income into capital gain. An outstanding example is the decision in *Rudco Oil and Gas Co. v. United States (Ct. Cls., 1949), 82 Fed. Supp. 746*, wherein the taxpayer declared a dividend to its stockholders which was paid by the corporation by assigning to them an oil payment out of oil properties owned by the corporation. Within three months the stockholders had received from the oil payment the amount of the dividend declared and thereupon the interest reverted to the corporation. The Court refused to permit this "device" to succeed and found the corporation taxable on all the oil runs which had been received by the stockholders.

It would seem not to be inappropriate to conclude this brief opposing the Government's Petition for Writ of Certiorari with a further comment on the question of whether the decision of the Court below in this case has done violence to the intent of Congress in enacting the capital gains provisions. In the instant case the oil interest sold and conveyed was 9 10 of the oil interest owned by the taxpayer. It consumed approximately five years to produce and sell enough oil from that interest to satisfy the amount of the oil payment. It is submitted that this transaction amounts to the sale of a substantial part of the interest owned by the taxpayer and is certainly vastly more than merely a *temporary* disposition of the taxpayer's rights to collect ordinary income. It was in fact, a sale of

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Compare *Commissioner v. Slaughter* and *Commissioner v. Hawn*, both supra.

a part of the income-producing asset or "tree" and not merely the "fruit" of the tree. Manifestly then, this is a conversion of taxpayer's capital investment to which Congress intended the capital gains provisions to apply.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the Petition for Writs of Certiorari should be denied.

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In the

Supreme Court of the United States

OCTOBER TERM, 1957

No. 108

FRANK SCOFIELD, Former Collector of Internal Revenue,
Petitioner,

v.

DENNIS M. O'CONNOR, *et al.*;
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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In the

Supreme Court of the United States

OCTOBER TERM, 1957

No. 108

FRANK SCOFIELD, Former Collector of Internal Revenue,
Petitioner,

v.

DENNIS M. O'CONNOR, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF FOR RESPONDENTS, DENNIS O'CONNOR, et al.

OPINIONS BELOW

The findings of fact and conclusions of law of the District Court in the *O'Connor* case (R. 74-78) are reported at 143 F. Supp. 240. The opinion of the Court of Appeals (R. 80-86) is reported at 241 F. 2d 65.

JURISDICTION

The judgment of the Court of Appeals was entered on February 1, 1957. (R. 87.) The petition for a Writ of Certiorari was filed April 17, 1957, and was granted June 3, 1957. This Court has jurisdiction under 28 U. S. C., Sec. 1254.

STATUTES INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939, being Section 117, are set forth in Appendix A., pp. 57-61, infra.

QUESTIONS PRESENTED

Is the cash sale in this case of a limited overriding royalty subject to capital gain treatment under Section 117 of the 1939 Code where, as found by both Courts below, the sale was bona fide; had a bona fide business purpose; was not a loan or mortgage; was not an assignment or anticipation of income; but was a sale of a real and substantial interest in taxpayers' properties.

STATEMENT

On Nov. 26, 1948, the executors of the Estate of Thomas O'Connor, deceased, transferred, by general warranty deed, duly recorded in the deed records of Refugio County, Texas, the entire royalty interest of the Estate under eight designated tracts of land to one D. E. Blackburn for the cash consideration of $9,990,350. The royalty interest sold to Blackburn had been held by decedent and subsequently by

his Estate for many years. (R. 74, 75.) The deed provided that after the royalties described therein had produced for Blackburn the prescribed quantity of oil, the properties would revert to the grantors. (R. 75.) Blackburn made a substantial profit on the transaction and reported and paid tax on his profit. (R. 76.)

The sale was made for the purpose of raising funds to pay Federal estate taxes, State inheritance taxes, Federal income taxes and administration expenses of the Estate. (R. 59-60, 76.)

This was the first and only sale of any type of mineral interests that the decedent or his Estate had ever made. (R. 76.)

The oil payment "paid out" after three years of production and during the time the royalties were owned by Blackburn. The oil payment would have taken an appreciably longer period to pay out had it not been for the fact that there was an increase in the production in the field because of the drilling of additional wells by the operating lessees and had it not been for the further fact that there had been a substantial increase in the price of oil shortly prior to the sale of the oil payment, which higher price was maintained during the period of the pay-out. (R. 76.)

If the sale is entitled to capital gain treatment, the tax on the sale is a little over $2,000,000. If, however, the proceeds are taxable as ordinary income, the tax, after allowance for depletion, will amount to over $5,600,000.

Based on a stipulation of facts and the uncontradicted testimony of two witnesses, the District Court made the following findings:

Both the sellers and the buyer, Blackburn, intended the transaction in question to be a sale and purchase of the royalty interest in question. They did not intend to enter into a loan or mortgage transaction. (R. 77.)

The transaction with Blackburn was a bona fide sale. (R. 77.)

The purpose of the sale was a bona fide business purpose. (R. 77.)

The transaction was not intended to be and was not, as a matter of fact or a matter of law, an assignment of income, but was the sale of a property interest to Blackburn, which property interest produced income in the hands of Blackburn. (R. 77.)

This property interest was substantial and real, representing a substantial part of the grantors' royalty interest. (R. 76, 77.)

The property so sold was a long-lived, and not a short-lived, oil payment. (R. 77.)

The property interest so sold to Blackburn was a capital asset as defined in Sec. 117 of the Internal Revenue Code of 1939, and this capital asset had been held by taxpayers for more than six months. (R. 77.)

The Circuit Court of Appeals, after reviewing the evidence, held that "on record made, the District Judge was right and his judgment should be affirmed." (R. 86.)

SUMMARY OF ARGUMENT

I.

A. Passing for the moment the "short-lived" oil payments, which will be discussed later, the following rules are clear:

1. The sale of a carved out oil payment is the sale of a property within the purpose as well as the letter of Section 117 (a). None of the stated exceptions are applicable. In the Committee Reports on the 1921 Act, Congress expressly stated that it intended sale of "mineral properties" to have the benefit of the lower rate. An oil payment is, without doubt, a "mineral property." Moreover, as pointed out by the Court in *Burnet v. Harmel*, 287 U. S. 103 (1932), to tax a long-lived oil payment at normal rates would produce "the kind of hardship aimed at by the capital gain provisions of the taxing act." The Government concedes that an oil payment per se is a capital asset; but its position is that Congress intended to give a different treatment to an oil payment carved out of a larger interest. The retention of a reversionary interest is said to convert what is otherwise admittedly a capital asset into an assignment of income.

2. The sale of a carved out oil payment is not an assignment of future income. It is utterly unlike a prepayment of rent or an advance sale of derivative income. It is not the sale of the fruits of a tree, but a sale of a large part of the tree itself. It is a bulk sale of a large number of barrels in place. It is not the temporary assignment of the fruits of property. It is the sale of a large number of the economic

units in place which are extracted and consumed by the new owner, which property the seller never regains on termination of the interest sold.

The sale of an oil payment is an anticipation of future profits only in the same sense that the sale of any depletable property is the anticipation of future income. This is because of the dual nature of all mineral property in that altogether they are property and altogether represent the right to future production and future profits. However, it is well settled that the outright sale of any mineral property (or a fraction thereof) is the sale of a capital asset despite the fact that the property has the unique quality of being also the right to future production.

Oil properties are unique and the sale of an oil payment is sui generis and such a sale is utterly unlike the assignment of income from a non-depleting corpus.

3. The retention of a reversionary interest does not convert that which is otherwise a capital asset into income. Various types of reversionary interests are involved in many different types of oil transactions and the retention of a reversionary interest or a possibility of reverter has never been thought to affect the character of what is sold. If the purchaser of a carved out oil payment has purchased a capital asset, as he clearly has, the seller must have sold one.

If by some remote analogy, a principle roughly akin to the *Horst* principle[1] is to be extended into this area, it seems

[1] *Commissioner v. Horst*, 311 U. S. 112 (1940).

obvious that while there may be some significance in the retention of a reversionary interest, if the oil payment sold is insignificant in relation to the property kept, such retention has no relevance whatever if the opposite is true and the oil payment is substantial and the reversionary interest remote.

The Government's position, as applied to long-lived oil payments, clearly violates the basic purpose of Congress in that it would create the very hardship which Congress sought to avoid in Section 117; also, its contentions literally applied, would mean that all sales of all mineral properties would be taxed at normal rates.

B. With respect to "short-lived" oil payments, a review of the administrative history discloses that for 25 years the policy of the Treasury was to recognize that all sales of carved out oil payments, irrespective of their substance or duration, were sales of capital assets within the meaning of the statute.

In 1946, the policy was changed and sales of "short-lived" oil payments (e. g., those ordinarily paying out in one or two years) were held to be subject to the normal rates. A similar rule was adopted relative to gifts,—gifts of "short-lived" oil payments were for the first time treated as assignments of future income.

In 1950, these rules were extended by I. T. 4003[2] to provide that all carved out oil payments, irrespective of size or duration, should be treated as assignments of income.

[2] *I. T. 4003, 1950—1 Cum. Bull. 10.*

After the Fifth Circuit refused to accept this extreme view as applied to oil payments having lives of from nine to 13 years, the Government has been urging the Insubstantial Transfer Rule, e. g., that those carved out oil payments which are substantial should have capital gain but insubstantial ones subject to normal tax treatment. Here it argues, first, for the extreme view of I. T. 4003 and alternatively for the Insubstantial Transfer Rule.

Three courses are open to the Court: (1) the extreme position taken in 1950 by I. T. 4003; (2) the other extreme (the rule for 25 years) that all oil payments are capital assets within the meaning of the statute; or (3) the Insubstantial Transfer Rule.

Of the three, clearly the extreme view taken in I. T. 4003 (the Government's primary contention here) is, for the reasons stated, clearly untenable. This ruling violates the basic purpose of the Act and is sheer legislation; there is nothing in the sale, for example, of the 12-year life oil payment in the *Fleming* case,[3] that even remotely resembles a prepayment of rent; it is no more the sale of income than the sale of the entire interest of any mineral property is the sale of income.

Of the two remaining courses, we believe the safest course, on constitutional grounds, is to follow the letter of the statute and leave the problem of the "short-lived" oil payment, to Congress if Congress deems it a problem. Here the letter of the statute and of the Committee Reports

[3] *Commissioner v. Fleming*, 241 F. 2d 78 (5th Cir. 1957), before this Court, on Writ of Certiorari, together with the instant case.

would be followed. Here the rule in force for 25 years and which has received implied legislative approval would be followed. The problem of the short-lived oil payment and its various ramifications in other areas, and of where a proper line should be drawn, is best left to Congress.

Alternatively, the Court should adopt the Insubstantial Transfer Rule, which is the Government's alternative proposition. Here the Court would be following the approach suggested in its previous decision in the *Schaffner* case,[4] by the Second Circuit in the *McAllister* case,[5] and by Judge Tuttle in the *Hawn* case.[6] This would make the question of whether the sale in a particular case is a sale of a substantial and durable property interest or simply the anticipation of income to depend on the facts of each case; its substantiality; its expected life; its relation to the reversion and whether the particular sale, under all the facts, appears to come within the stated intent and purpose of Congress. Such determination as in *Clifford*[7] and *Culbertson*[8] would be left to the trier of the facts.

Thus the Court should either affirm all the cases or should adopt the Insubstantial Transfer Rule. If such rule is adopted the Court should make this the rule of law to be applied in these cases, and, for the guidance of the lower courts, indicate, as in *Culberston*, the factors to be considered in each case. In such event, the Court should remand

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[4] *Harrison v. Schaffner, 312 U. S. 579 (1941).*

[5] *McAllister v. Commissioner, 157 F. 2d 235 (2d Cir., 1946), cert. den. 330 U. S. 826.*

[6] *Commissioner v. Hawn, 231 F. 2d 340 (5th Cir., 1956).*

[7] *Helvering v. Clifford, 309 U. S. 331 (1940).*

[8] *Commissioner v. Culbertson, 337 U. S. 733 (1949).*

some of the pending cases for a determination of substantiality.

II.

If the Court should adopt the Insubstantial Transfer Rule, the *O'Connor* case should, in any event, be affirmed; a remand here is unnecessary since the trier of facts has made all essential findings: (1) that the oil payment in question was long and not short-lived; (2) that the taxpayers sold a substantial and real property interest, representing a substantial part of taxpayers' royalty interest; and (3) that taxpayers did not assign income but sold a capital asset within the meaning of Section 117. Such findings, supported by the record and by the Court of Appeals, are entitled to finality. Of course, if the Court leaves the matter of "short-lived" oil payments to Congress, our primary contention, this case must be affirmed.

ARGUMENT

Part I—The Legal Principles

The broad question in this case is whether the sale of a carved out oil payment is the sale of a capital asset under sec. 117 or a sale of (the anticipation of) future income. The answer involves the consideration of the treatment to be accorded the "long-lived" oil payment, the "short-lived" oil payment and those in between. Underlying is also the Constitutional question of the scope of this Court's power to legislate the sensitive area of tax rates.

The Government contends (1) that the sale of all carved out oil payments, irrespective of life, are to be treated as assignments of future income; and alternatively, that those insubstantial in nature should be so considered but that those which are substantial should be given capital gain treatment.

We believe the problem can best be handled if we first consider oil payment sales generally, viewing such sales both from the standpoint of the Congressional intent and purpose and from the standpoint of the anticipatory assignment of income rules. Following this general treatment we will then deal specifically with the problem of the short term oil payment and consider the three possible courses open to the Court.

This Part I of the brief will be confined to the legal principles. Part II will consider the facts and findings in the *O'Connor* case in light of such principles.

A.

Oil Payment Sales Generally

Before considering the problem of the short term versus the long term oil payment, two general principles must be first recognized: (1) That Congress intended to extend capital gain treatment to sales of carved out oil payments, and (2) that the sale of an oil payment, at least a long term one, is not a sale or assignment of future income.

1. *The Sale of an Oil Payment is the Sale of a Capital Asset Within the Intent and Purpose of Sec. 117, as well as its Letter.*

Oil payments are not simply a tax device designed to convert ordinary income into capital gains. Oil payments were a recognized form of mineral interest long before the adoption of the capital gain provisions in 1921. They have played an important part in the development of the vital oil industry, and serve many useful functions in the day to day operations of that industry.[9] Oil payments are, every day, assigned to drilling contractors for the drilling of oil wells; to supply houses for the equipping of wells; to geologists, petroleum engineers, land men, lawyers and others to assist in the search for oil or in the development of oil properties. They are sold or pledged to secure funds for development.[10] They may be carved out and retained in connection with a farm-out or other grants. Most sales of producing properties are accomplished through the oil payment or so-called ABC transaction.[11] In partial or complete liquidation of an oil corporation, an oil payment, for sound business reasons, may be transferred to one or more of the shareholders, and the working interest, subject to the oil payment, to other stockholders. Oil payments may be given to charity or in trust or otherwise to a member of the family.

[9] For the convenience of the Court, we have summarized in Appendix B, p. 63 infra., the tax treatment accorded to various oil transactions including the various transactions in which oil payments play a part. On the general subject of the various uses and their tax treatment see, *Trevathan, Federal Tax Aspects of Oil Production Payments*, 35 *Taxes, The Tax Magazine* 179 (1957).

[10] See Tax Treatment, Appendix B, p. 68 infra., *Development Oil Payments*.

[11] See Tax Treatment, Appendix B, p. 71 infra., *The ABC Transaction*.

By will, a widow may be devised an oil payment and the working interest, subject to the widow's oil payment, devised to the sons. Thus they have many uses.

Oil payments, however created, and for whatever purpose, are property. Under the law of Texas and most of the twenty or thirty oil producing states, they are real property.[12] They are also property under the federal tax laws, being an economic interest in oil in place. *Thomas v. Perkins, 301 U. S. 655 (1937); Anderson v. Helvering, 310 U. S. 404 (1940).*

Since the sale of an oil payment is the sale of "property" it falls within the letter of Sec. 117.[13] Unless the seller is a dealer, buying, selling and trading in oil properties, the sale does not fall within any of the enumerated exceptions prescribed by the statute. If the sale, as in the *O'Connor* case, is out of a royalty interest, it is a sale of a part of the taxpayer's investment property; it is not a sale of stock in trade or of inventory or of property held primarily for sale to customers in the ordinary course of a trade or business. The royalty owner, generally, is not engaged in a trade or business, and the Court found that the taxpayers in the *O'Connor* case were not so engaged. (R. 76.) If the sale is out of a lease or working interest,[14] it is the sale of "real property used in (the seller's) trade or business," and thus literally falls within the provisions of Section 117(j) unless, again, the seller is regularly engaged in the business of trading in leases.

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[12]See Tax Treatment, Appendix B, p. 66 infra, *Oil Payments.*

[13]Appendix A, p. infra.

[14]See Tax Treatment, Appendix B, p. 63 infra, *Lease.*

The sale is also within the intent and purpose of Section 117. The capital gain provisions were incorporated in the revenue laws by the Revenue Act of 1921. In its report on this new provision, the Ways and Means Committee stated (Report—Ways and Means Committee, 67th Cong., 1st Sess., H. Rept. 350):

> "The sale of farms, *mineral properties*, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. * * * In order to permit *such transactions* to go forward without fear of a prohibitive tax, the proposed bill, in section 206, adds a new section. * * *."[15]

An oil payment is certainly a "mineral property," and, as the Committee Reports clearly show, Congress intended to permit sales of such to go forward at the new capital gain rates.

In *Burnet v. Harmel, 287 U. S. 103 (1932)*, this Court held that the current production and sale of royalty oil, though technically a sale of property, was not within the intent and purposes of the capital gain provisions. Taking note of the foregoing Committee Reports, this Court there said:

> "The provisions of the 1921 Revenue Act for taxing capital gains at a lower rate * * * were adopted *to*

[15] Seidman's Legislative History of Federal Income Tax Laws, p. 813. Likewise in the Report of the Senate Finance Committee (67th Congress, 1st Sess., Senate Report 275), it was stated:

> "* * * Under the present law many sales of farms, *mineral properties*, and other capital assets have been prevented by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum and the amount of surtax excessively enhanced thereby. In order to permit such transactions to take place without fear of prohibitive tax, section 206. * * *."

relieve taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions. * * *.

"But notwithstanding this incidental transfer of ownership, it is evident that the taxation of the receipts of the lessor as income does not *ordinarily* produce the kind of hardship aimed at by the capital gain provisions of the taxing act. * * * (T)heir abstraction from the soil is a time-consuming operation and the payments made by the lessee to the lessor (sic) do not normally become payable as a result of a *single transaction* within the taxable year, as in the case of a sale of property * * *.

"* * * Such operations * * * have been said to resemble a manufacturing business." (Emphasis added.)

Under this decision the sale of an oil payment must be regarded as falling within the purpose and intent of Section 117 as well as its letter. It is a sale of realty, not of personalty. It is a bulk sale of a large quantity of oil in place which is, and remains, realty. Here we do not have the day-to-day, recurring conversion of realty into personalty. We do not have the time-consuming operations involved in daily sales. There is nothing that slightly resembles a manufacturing process. The sale is "a single transaction within the taxable year as in the case of the sale of property." The sale falls within the purpose of Section 117, which was "adopted to relieve the taxpayer from the excessive tax burdens resulting from a conversion of capital investments." To tax the sale of most oil payments as normal income would "produce the kind of hardship aimed at by the

capital gain provisions" since it would "bunch" in a single year and tax at surtax rates graduated up to 91%, not just six months of profits, but profits of a number of years.

Unless the Court is prepared to overrule its decision in the *Harmel* case, the sale of an oil payment must be regarded, under that decision, as falling within the purpose and intent, as well as the letter, of Section 117.

The Government admits that an oil payment, per se, is a capital asset within the meaning of Section 117. If a taxpayer has purchased an oil payment and six months later sells it, or a fraction of it, it is acknowledged that he has sold a capital asset and is entitled to capital gain treatment. If on sale of a mineral property the seller carves out and retains an oil payment and later sells the oil payment, or a fraction thereof, it is recognized that he has sold a capital asset. If a development oil payment is carved out of a larger property and assigned to another for cash which is earmarked or pledged for development, or is assigned to a geologist or engineer for his services in engineering or developing the property, it is recognized that the new owner of the oil payment holds an economic interest in oil in place and should he sell it, or a fraction of it, he has sold a capital asset. Such oil payments are acknowledged to be capital assets, even though their economic life be as short as one or two years.[18]

[18] See Tax Treatment, Appendix B, pp. 66-68, infra, *Oil Payments. Development Oil Payments.*

Thus it is the government's position that all oil payments are capital assets except those carved out of a larger interest (then only if the proceeds are not earmarked or pledged for development). As to such payments the taxpayer is held not to have sold property within the meaning of Sec. 117, but to have assigned future income.[17]

2. *The sale of a carved out oil payment is not the sale of or anticipation of future income.*

If a taxpayer receives a prepayment of rent he is in receipt of normal income and must pay tax at normal rates in the year of receipt, whether he be on the cash or accrual basis of accounting. The lessee amortizes his rental payment over the period to which the payment relates. Likewise we may assume that if a taxpayer sells to a third party his right to receive future rents from property, or dividends declared and unpaid, or interest on a bond yet unaccrued, he will be deemed to have sold income as such and his receipt is to be taxed at normal rates. What he receives is but a substitute for what he would have received had he

[17]We do not deem it necessary to labor the point made by the Government (Br. 33-41) that the sales in question were not sales of property but "conferred only a contractual right." We do not know what this means unless a deed passing title to real property, duly delivered and recorded in the county where the property is located, conferred a "contractual right." Of course, a contractual arrangement could exist, such as a guarantee of the oil payment. This would cause the seller to be taxed on the income from the oil payment received by the buyer as it paid out and would eliminate all tax on the proceeds of the sale. See Tax Treatment, Appendix B, p. 69, infra, *Guaranteed Oil Payments*. No "contractual arrangement" was present in the *O'Connor* case, except the sale itself. (R. 75.) Also we pass the contention that at most the assignments conveyed oil, which is not a capital asset. (Br. 42.) Of course, every sale of every mineral property conveys only oil,—oil in the ground.

not anticipated his income by the sale.[15] However, a sale of a carved out oil payment is not the sale of income in the sense of a prepayment of rent or the sale of future dividends or the sale of coupons clipped from a bond. Rents, dividends and interest represent income "derived from" capital. They are payments received for the use of money or property; and, when received, they are separated from the producing corpus; they are the earnings or products of the corpus; the corpus remaininng intact, capable of producing income in future years. The right to receive rents, dividends and interest is an intangible property right, a contractual right, but their identity as income—as derivative of and separate and apart from the corpus—is clear and unmistakable.

But profits from the production and sale of oil is not income "derived from" an income-producing property. It is not income in this derivative sense at all; it is the profit derived from the sale of property. Any interest in an oil and gas property, whether that interest be an oil lease, a royalty, or a limited overriding royalty or oil payment, represents title to and ownership of a specific number of

[15]There are a few rules to this effect, although the extent of the rule is yet to be developed. *Lum v. Commissioner of Internal Revenue, 147 F. 2d 356 (3rd Cir. 1944).* Whether the rule would be extended to the sale of the right to the use and occupancy of a property for a term of years or whether it would be extended to the sale of all of the coupons on a ten or twenty year bond is yet to be announced. The cases relied on by the Government relating to the sale of income *already earned* are clearly irrelevant. They involve another principle that *earned* income was intended to be taxed to the earner at normal rates and one who has already earned income may not, by an anticipatory sale, convert this chose in action into a capital asset, c.f., *Safety Car Heating Co. v. U. S., 297 U. S. 88 (1936).* See also, *Beard, 4 T. C. 756 (1945) (A); Hobby, 2 T. C. 980 (1943) (A),* and compare *Henrietta Mills, Inc. v. Commissioner, 52 F. 2d 931 (4th Cir. 1931),* and *F. Rodney Paine v. Commissioner, 236 F. 2d 398 (8th Cir. 1956).*

barrels of oil under the ground. The number of barrels in place is limited. They may be comparatively few in number, or, as in the case of the East Texas Oil Field, they may be in sufficient quantity to give the property a life of perhaps 30 years. But as each barrel is produced and sold, that barrel is gone forever, and gradually as additional barrels are produced and sold, all will sooner or later be gone. This oil in place is real property. When a barrel of oil is produced, it is converted at the surface into "personalty," but it is still tangible property. When the barrel of oil is sold, there is a gain or profit on its disposition. This gain or profit is the difference between the unit cost of that barrel of oil and its selling price,[18] but this profit is obviously not income such as rents, dividends or interest, which are derived from a non-depleting corpus. It is the profit from the sale of property. To use the hackneyed illustration, the sale of a barrel of oil is not the sale of the fruits from the tree; it is, rather, the sale of a piece of the tree itself.[19]

Nor is the sale of an oil payment the sale of income to be derived from a retained corpus. It is the sale in bulk of barrels of oil in place. It is the sale of real property, not an intangible right to income to be derived from real property. It is a sale of a large part of the property or the "tree." That which is sold is not "derived from" that which is kept.

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[18] Under the Treasury Regulations, the cost of the entire oil property is divided by the estimated number of barrels of oil in place, in order to arrive at a unit per barrel cost. Regulations 39.23 (m)-2 under the 1939 Code. Of course, the taxpayer may use statutory depletion in lieu of cost depletion.

[19] Under the *Harmel* decision, this recurring, piecemeal, day-to-day sale is taxed at normal rates, not because it is "derivative income" but because, though literally a sale of property, it is not the type of [illegible] recurring, isolated profit which Congress had in mind in enacting the capital gain provisions.

The retained property, representing the reversionary interest, is not the corpus, nor is the oil payment the income to be derived from that corpus. The oil payment on the one hand, and the reversionary interest on the other are separate and different parts of the mineral content in place. The sale of an oil payment is not the temporary assignment of the fruits from property. It is the absolute disposition of property itself, which property is extracted and consumed by the buyer, and which property never comes back to the seller. Clearly, the sale of an oil payment is not a sale of derivative income, as in the case of the advance sale of interest, dividends or rents.

The sale of an oil payment is not the assignment of income from property. It is, however, the *anticipation* of future income in the limited sense that it is a sale of property that carries with it the right to future production and profit. It is a sale of or anticipation of future income only in the sense that had the sale not been made and had the oil been retained and produced on a barrel by barrel basis, this same oil would, under the *Harmel* decision, have been taxed at normal rates, when and as produced. In this sense, the sale of any mineral property, hardrock or hydrocarbons, involves the sale of or anticipation of future income. This is because of the depletable nature of all mineral deposits. All mineral properties are "property", and at the same time in their entirety, represent future profits. Any mineral property, kept and produced to the end of its economic life (whether it be two years or twenty), will all be ordinary income. After exhaustion there will be no property left

because all of its has been consumed in the productive process. Thus the sale of any mineral property is the sale of property, carrying with it the right of future production ..til fully consumed. In this sense it is also the sale of the right to future profits.

It is the unique and dual nature of a mineral property, being at the same time both property and all future profits, that apparently has been overlooked by the government. If the sale of an oil payment, though clearly a mineral property, is to be taxed at normal rates simply because it also includes the right to future production, then every sale of every mineral interest must be taxed in the same way for the same reason. Yet such is not the case. Nor does the government contend for this position.

All of the decisions since the *Harmel* case have consistently recognized that mineral properties, including leases, royalties and oil payments, are capital assets, even though oil proceeds are normal income and even though the sale of the property, or a portion thereof, carries with it this inherent right to future income.[21] As stated in *J. E. Murphy v. Commissioner, 9 B. T. A. 610, 616 (1927) (Acq.), affirmed without opinion Ct. App. D. C. Feb. 10, 1930*, in al-

[21] See *W. P. Ferguson v. Commissioner, 45 F. 2d 573 (5th Cir. 1930); Burkett v. Commissioner, 31 F. 2d 667 (8th Cir. 1929); Chesson v. Commissioner, 57 F. 2d 141 (5th Cir. 1932); Glide v. Commissioner, 75 F. 2d 1014 (9th Cir. 1935); Hirschi v. U. S., 67 Ct. Cls. 637 (1929); Henry Berg, 33 F. 2d 641 (D. C. Cir.), cert denied, 280 U. S. 615 (1930); D. R. McDonald, 7 B. T. A. 1078 (1927); J. D. Reynolds, 10 B. T. A. 651 (acq.), affm'd on authority of Berg, et al. v. Commissioner (D. C. Cir.), Feb. 20, 1930; J. E. Murphy, 9 B. T. A. 610 (1927) (acq.), affm'd without opinion (D. C. Cir.), Feb. 10, 1930; Hazlett, 10 B. T. A. 332 (1928); Parkey, et al., 16 B. T. A. 441 (1929); Abel Bliss, 16 B. T. A. 538 (1929); Eli K. Price Est., 23 B. T. A. 1192 (1932); Goforth, 32 B. T. A. 1206 (1936).*

lowing capital gain treatment on the sale of a royalty interest:

> "To hold otherwise would be to give to a relief statute a narrow construction which would do violence to the intention of Congress as expressed both in the words of the section and the report of the Committee on Ways and Means of the House of Representatives."[22]

This has also been the consistent practice of the Service, both before and after the *Harmel* case.[23]

Obviously, therefore, mineral properties are sui generis. They are unlike other forms of property. They are relatively short-lived, and thus unlike other forms of property having perpetual life. They are depletable, and thus are unlike other properties capable of reproducing income forever. They are unique in that they are property and at the same time future profits; but this future profit is unlike the dividends, interest and rents derived from a non-depleting corpus. Because of their unique nature it is clear that the sale of an oil payment is utterly unlike the sale of

[22]Here the Court was referring to the stated intent in the Committee Report that sales of "mineral properties" should have the benefit of the capital gain rates.

[23]*I. T. 2017, III-2 C. B. 47; GCM 4299, VII-2 C. B. 116; Rev. Ruling 55-526, 1955-2 C. B. 574.* Thus, in *G. C. M. 12118, XII-2 C. B. 119 (1933)*, published shortly after the *Harmel* decision, it was stated:

> "* * * The case of *Burnet v. Harmel*, supra, establishes the principle that all payments from lessee to lessor under an oil and gas lease are income from the use of the land and are not gain from the sale or conversion of capital assets. This rule should be applied in all cases where the instrument of grant may be classified properly as a lease. This office is of the opinion, however, that in the case of an unlimited conveyance for a cash consideration of the lessor's reserved royalty under an oil and gas lease or of a fractional interest therein, as in the case of *J. E. Murphy v. Commissioner*, supra, and the *Appeal of Anna Taylor*, supra, the conveyance may be treated as a sale of a capital asset within the purview of the capital gain provisions."

dividends declared and unpaid or coupons clipped from a bond. Cases dealing with such sales have little bearing and even less applicable are the donative assignment of income cases where the question is *who*, among the members of a family group, shall be taxed following a gift of future derivative income, the donor retaining the corpus that produces it. Here the question is, did Congress intend to give capital gain treatment to the sale of this unique mineral property.

All the cases hold, and the Government acknowledges, that Congress did intend to give capital gain to the sale of an oil payment (or other mineral property) even though the property has only a two or three year remaining life, provided the taxpayer sells all of it or a fraction of it, but the Government's position is that Congress did not intend capital gain treatment if the taxpayer sells a two or three year life oil payment, out of a larger interest, retaining a reversionary interest. Both oil payments are real property under state law; both represent economic interests in oil in place under Federal tax laws; both are "property" within the letter of sec. 117; both are "mineral property" within the stated purpose of the Committee Report; quantitatively, both represent the ownership of the same number of barrels of oil in place; and both involve to the same degree the right to future production. The only difference is that in the one case the taxpayer has sold all (or a fraction of all); in the other he has retained a reversionary interest. Did Congress intend to deny capital gain treatment simply because the seller has retained a reversionary interest?

Logically the retention of a reversion should not affect the character of what is sold; or convert what is otherwise a capital asset into normal income. Certainly the carved out oil payment in the hands of the buyer is a capital asset, and if he should sell it six months after purchase he would, admittedly, have capital gain.[24] If the buyer has bought a capital asset, logically, the seller must have sold one.

In any event its seems abundantly clear that even though the retention of a reversion may be deemed to have some significance if the oil payment is small and the reversion very large, the same retention of a reversion has no significance whatsoever if the reverse is true and the oil payment is very large and the reversion so small as to become not a reversion, but a mere possibility of reverter.

In the oil industry, sales of property are frequently made subject to various reservations. Such reservations have never been thought to affect the character of the property that is sold. Thus, the sale of a landowner's royalty under an oil and gas lease, is the sale of a capital asset even though the minerals will revest in the landowner on termination of the lease.

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[24] I. T. 4003, 1950-1 C. B. 10; *Thomas v. Perkins*, 301 U. S. 655. (1937.) The Government's contention that the assignments "conveyed to the assignees only the contractual rights to collect a portion of the *assignors'* future oil proceeds (Govt. Br. 39.) is obviously contrary to the law and facts and is utterly unrealistic. The assignees, by recorded deed obtained title to oil in place,—a real property interest. They alone thereafter owned the oil; they alone could sell it; or they could have taken it in kind; if a blowout or other loss occurred, the risk was theirs. As owners they could produce it, sell it or borrow against it. The very fact that the Government suggests a distinction in the case of the development oil payment (Fn. 19; Fn. 39) points to the fallacy. What is the source of this distinction? Certainly the character of an oil payment as an economic interest in oil in place, as explained in *Thomas v. Perkins*, supra, is not affected either by the circumstance of its creation or the use of the funds received from its disposition.

A sale of a lease is the sale of a capital asset even though the buyer be required to drill a well or to perform other acts which if not performed will cause the property to revert. The sale of a lease is the sale of a capital asset, though the seller may reserve the deep rights. An agreement, on the sale of a lease, that the buyer shall drill a well; that if it be an oil well the buyer keeps it, but if it be a gas well the property revests in the seller, does not affect the capital gain character of the properties sold.

The carried interest [2] is a capital asset, and the sale of property subject to a carried interest contract will entitle the seller to capital gain despite the provision that a fractional interest will revest in the seller after the buyer has recouped his cost. Also the sale of a royalty or a lease is subject to capital gain though the seller retains an oil payment.

We submit the reversionary interest or possibility of reverter retained on the sale of an oil payment, certainly as to a long lived oil payment, does not change the character of the asset sold.

Up to this point we have been discussing the sale of carved out oil payments generally. As to long-lived oil payments, the following conclusions are, we submit, entirely sound and not open to serious question:

1. The sale of a long lived oil payment is the sale of a capital asset within the clear intent and purpose of sec. 117, as well as its letter.

[2] See, Tax Treatment, *Carried Interest*, Appendix B, p. 73, infra.

2. The sale of a long-lived oil payment is not the sale or assignment of income from property.

3. The retention of a reversion in the case of the sale of a long-lived oil payment does not convert the oil payment into something other than a "mineral property."

We now turn to the problem of the "short-lived" oil payment.

B.

The Problem of the Short-Lived Oil Payment

Despite the validity of the general principles above discussed, it might be conceded that the statute as written should be revised to deal with the problem of the sale of carved out oil payments of relatively short duration. While the sale is a sale of a mineral property, this property carries with it the right to the first production. Discountwise, the first production is the most valuable oil in place. Since the buyer is entitled to the first production his risk, in the case of settled production, may be so slight as to justify his paying a price only a little under the anticipated revenues from the property.[25] Where the oil payment is "short-lived" or "insubstantial" and the reversionary interest relatively large, one unconsciously is inclined to emphasize this right to the first production and to look only on the one side of the oil payment coin which says, "This is the right to future production; this is the anticipation of

[25]Of course the same is true of the outright sale of any oil payment or royalty interest, the life of which is short and its productivity over its remaining life ascertainable. The difficulty with the "short-lived" oil payment lies not in the degree of risk or certainty of pay out, but in its insubstantiality in relation to the interest retained.

future profits"; but as the life of the oil payment is extended and its substantiality increases, the first impression that the sale is but the anticipation of future income recedes and one sees only the side of the coin which bears the inscription, "This is, indeed, a mineral property." It is this dual nature of mineral property, being both a mineral property and at the same time the right to future production that makes a "short term" oil payment appear to be an "assignment of future income." It is not an assignment of income but it is an anticipation of future profits, just as the sale of any short lived mineral property is. It is also the sale of a mineral property.

In certain well defined situations Congress might well have recognized that the sale of a "short-lived" oil payment, though the sale of a mineral property, was, in effect and as a practical matter, only an anticipation of future income. Congress could have done any one of several things. It could have said that the sale of any mineral property, whether it be the sale of a carved out oil payment or the sale of an entire interest, should be denied capital gain treatment if it had a life of no more than one or two years. Or it could have denied capital gain treatment to all sales of carved out oil payments; or it could have said that carved out oil payments having an anticipated life of no more than one, two or five years should be excepted. Or it could have excluded carved out oil payments where the interest sold did not represent more than 10%, or some other percentage, of the underlying reserves.

The trouble is, Congress has done none of these things, and has simply stated that it intended to give capital gain treatment to the sale of "mineral properties." The question here is whether this Court, within the limits of its Constitutional power of interpretation, shall attempt to do what Congress has not done.

Before taking up the three courses open to the Court, a brief history of the judicial and administrative treatment of short term oil payments may prove helpful.

Aside from the lower courts' decisions in these cases, there are several older cases which apparently have received implied legislative approval, all of which have recognized that the sale or assignment of all carved oil payments, "short-lived" and "long-lived" alike, were sales or assignments of property, not of future income, and the existence of a reversionary interest did not change the character of the property so conveyed.

Thus in *R. E. Nail, 27 B. T. A. 38*, decided in 1932, the taxpayer made a valid assignment of an oil payment out of his royalty interest, to a trust. The oil payment "paid out" in less than a year. The Court said:

> "Here it is apparent that there was a complete transfer of decedent's present interest in the property. She kept a reversionary interest, but that gave rise to no income. The income here involved arose from the property conveyed and belonged, not to Mrs. Cook, but to the trust."

The Treasury acquiesced in this decision (Acq. XII—1 Cum. Bull. 3, 1939).

In *Ortiz Oil Company, 37 B. T. A. 656, affirmed by 102 F. 2d 508 (5th Cir., 1939)*, a corporation sold an oil payment out of a larger interest; the oil payment paid out in less than four years. The Board of Tax Appeals (at page 664), affirmed by the Fifth Circuit, held, in unmistakably clear language, that a *sale* of property had been made by the taxpayer:

> "The transaction constituted a *sale* by petitioner *of oil in place* and it *realized taxable gain* thereon in the amount of $154,000 less the amount of the cost bases allocable to the oils required to discharge the oil payments. * * *." (Italics supplied.)

Again in *Majestic Oil Corporation, 42 B. T. A. 659*, decided in 1940, the taxpayer sold a carved out oil payment for $63,500 cash and claimed depletion on the sale. There the Government took the position, diametrically opposed to its present position, that (p. 664):

> "The $63,500 received by the petitioner from Royalty during 1935 was *not 'income from the property'* within the meaning of section 114(b) of the Revenue Act of 1934; that the petitioner *sold an economic interest in its lease* with Shell to Royalty [Royalty was the purchasing company], and under the decision of the Supreme Court in *Thomas* v. Perkins, 301 U. S. 655, the petitioner is not entitled to depletion in respect of the $63,500 received from the *sale of such economic interest.*" (Italics supplied.)

The Board of Tax Appeals, relying on the *Ortiz* case, supra, sustained the Government's position.

See also *Nordan, 22 T. C. 1132 (1954)* (Government's appeal dismissed) (gift of an oil payment to a church held to be gift of property and not of future income).

Thus all of the decisions since 1932 are contrary to the Government's present position. There are none in its favor. During these years Congress has repeatedly reenacted the capital gain provisions. While numerous amendments have been adopted to remedy certain defects, no change has been made in the provisions giving capital gain to the sale of mineral properties. The rule of implied legislative approval is applicable.

In addition, for twenty-five years following the enactment of the capital gain provisions in 1921, it was the consistent policy of the Treasury Department to recognize that sales of carved out oil payments were entitled to capital gain treatment, even though the oil payment had only an expected life of a year or two. During this period, many private rulings to this effect were issued. It was this policy that caused its acquiescence in the *Nail* case, supra, in 1932. And it was this policy that the Government itself successfully urged in the *Ortiz* case, supra, in 1939, and again in the *Majestic* case, supra, in 1940.[27]

This long established administrative policy, it can be said, received Congressional approval through the repeated re-enactment of the statute without change.

[27] And see G. C. M. 22730, 1941-1 Cum. Bull. 214, where it was said:

"Unlike ordinary rights to rent or royalty, oil payment rights represent share rights in only a portion of the oil or mineral content of the land. When the stipulated payments are made, the payee's interest in oil or mineral expires. A cash payment made upon the execution of an instrument stipulating only for oil payments is, therefore, regarded not as an advance royalty payment but as proceeds from a sale in which the payee disposed of his economic interest in oil or mineral in place, less the fraction thereof represented by the oil payment rights reserved by him."

Not until 1946 (25 years later) was there any change in this settled policy. In that year the Treasury detected what it thought was a defect in the law in applying capital gains to short lived oil payments. Instead of asking Congress for an amendment to the capital gain provisions, it undertook to cure the defect administratively.

1. First, in 1946, it promulgated G. C. M. 24849, 1946—1 Cum. Bull. 66. This ruling denied capital gain treatment to "short-lived" oil payments; e. g. those, as stated in the ruling, that "ordinarily pay out and expire within one or two years."[28]

2. In 1949 it ruled that *donative* assignments of "short-lived" oil payments carved out of a larger interest are "assignments of future income." I. T. 3935, 1949—1 Cum. Bull. 39.[29]

3. In 1950 both of the foregoing rulings were extended to cover all carved out oil payments, irrespective of life. The sale of such an oil payment was held to result in ordinary income; and a donative assignment was considered as the assignment of future income. I. T. 4003, 1950—1 Cum. Bull. 10.[30].

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[28] Since the taxation of the sale of "short-lived" oil payments as ordinary income represented a change in existing policy, G. C. M. 24849 was made to apply to such sales made after April 1, 1946, (I. T. 3895, 1948-1 Cum. Bull. 39). Miller, in an article entitled "Selling 'Oil Payment'," 27 Taxes, The Tax Magazine 185 (1949), discusses G. C. M. 24849.

[29] In that ruling the previous acquiescence in the *Nail* case, supra, was withdrawn. Again since this ruling changed existing practice, the ruling was effective only to donative assignments made after January 24, 1949.

[30] This new ruling was expressly held not to apply where the assigned oil payment right constitutes the entire depletable interest of the assignor or a fraction extending over the entire life of the property.

4. After the *Caldwell* case refused to follow I. T. 4003, the Government, in the *Hawn* case,[41] and again in the court below, receded from the extreme position in I. T. 4003 and argued for the Insubstantial Transfer Rule, e. g., that substantial carved out payments should be allowed capital gain but insubstantial ones should be regarded as sales of future income. This Insubstantial Transfer Rule, in substance, was the readoption of the 1946 ruling of the Bureau (G. C. M. 24849) that "short-lived", as distinguished from "long-lived" oil payments, should be taxed as ordinary income.

5. In its brief here, the Government now withdraws its previous concessions that I. T. 4003 went too far, and reasserts its former position that all sales of all carved out oil payments, irrespective of life, are assignments of income. Only alternatively does it contend for the Insubstantial Transfer principle.

As this administrative history shows, the problem of the "short-lived" carved out oil payment is not new. Three different positions have been taken since 1921, and three courses are open to the Court:

(1) To adopt the position taken in 1950 in I. T. 4003 (the Government's primary contention here) that the sales of all carved out oil payments, regardless of anticipated life, are sales of income;

(2) To follow the clear language of the statute and committee reports and allow capital gains to all carved out oil

[41] *Commissioner v. Hawn*, 231 F. 2d 340 (5th Cir., 1956).

payments, even the short lived ones (the policy of the first 25 years), and leave the short lived problem to Congress.

(3) To adopt a middle ground, and limit capital gains to substantial oil payments (in effect to adopt the 1946 ruling).[32]

1. *I. T. 4003 (the Government's Primary Contention) is Clearly Wrong.*

It is respectfully submitted that I. T. 4003 (the primary contention of the Government) is, without question, wrong. I. T. 4003 holds that every carved out oil payment, no matter how substantial or how long its life, is to be denied capi-

[32]We omit, as a possibility, the adoption of the "loan" theory of the Seventh Circuit in *Commissioner v. Slagter*, 238 F. 2d 901 (1957). There, the Court treated the sale of a carved out oil payment as if it were not a sale at all but a loan or advance, thus holding the seller should remain taxable on the income in the hands of the purchaser, with the result that there was no tax on the sale at all (normal or capital gain). Thus the Court adopted a very literal application of the donative assignment of income cases. The decision is favorable to the taxpayer in these cases, since it would mean that the Government has asserted the wrong tax in the wrong years, and there would be no tax due in the years before the Court and limitations will have barred collection in the later years. However, we believe the *Slagter* case is wrong and the Government agrees that the *Slagter* case is wrong. The claim of right doctrine now advance by the Government (Gov. Br., Fn. 11) is clearly applicable. If the sale is bona fide, the taxpayer should account for the consideration in the year of receipt when it is subject to his unqualified disposition and command. He should not be taxed on another's income in other years. As a matter of sound taxing policy, he should pay his tax when he gets the money and the Government should not depend on his ability in future years to pay the tax. If the seller is not taxed on the cash receipt and the oil payment never pays out, the buyer will have a loss and the seller a tax-free windfall. Moreover, if the tax is not collected immediately, the tax will be lost should the seller die before the oil payment pays out. The most favorable thing that can be said for the *Slagter* case is that it produces a more equitable result than I. T. 4003 in that it spreads the tax in lower brackets over a number of years rather than grouping a number of years of profits in a single year. We submit the case is wrong, although it does illustrate the confusion resulting from attempted application of the donative assignment of income cases. Of course, the *Slagter* result would be right if the sale is not bona fide or if the oil payment were guaranteed. See Tax Treatment, *Guaranteed Oil Payment*, Appendix B, p. 69, infra.

tal gain treatment, simply because of a reversionary interest, or a possibility of reverter. It holds that all long-lived oil payments, even those extending to the full economic life of the property, are to be taxed as ordinary income. This would include the 13 year life oil payment in the *Caldwell* case and the 12 year life oil payment in the *Fleming* case. Here there can be no question about the Congressional intention. Certainly such long lived oil payments are "mineral properties" within the clear and unambiguous purpose of sec. 117, as expressed in the 1921 Committee Reports. To tax such long lived oil payments at ordinary rates would, without question, tax many years of profits in a single year at the highest surtax rates, and thus produce an extreme hardship, the avoidance of which was the principal aim of Congress in enacting the capital gains provisions, as this Court so clearly pointed out in the *Harmel* case.

All oil properties, sooner or later, exhaust themselves. Some have longer lives than others. The average life of an oil well is ten years or less. Admittedly the sale of the entire interest in an oil property (or a fraction thereof) was intended by Congress to have capital gain treatment. Can it be said, by any process of reasoning, that while Congress intended an entire interest having a life of less than ten years to be a capital asset, a carved out oil payment having a twelve year life should not be? The Government has pointed to no exception or other provision in the statute even slightly intimating such a distinction. Can it be said that Congress intended that one taxpayer owning an oil

payment having a life expectancy of only two years should have capital gain on its sale; but another who sells an oil payment out of a larger interest with an expected life of 20 years is to be taxed at 91%? Did Congress intend that A, who sells an entire oil payment representing 1,000 barrels of oil, should have capital gain; but B, who sells one involving one million barrels in place, has ordinary income if he retains a reversionary interest of so much as a single barrel? Did Congress intend that if a taxpayer should sell an undivided 10% interest in his royalty representing 1,000 barrels of oil in place, he is entitled to capital gain; but if he sells a carved out oil payment, representing the first million barrels of oil in place and representing 90% of his property, he has ordinary income because he has retained a reversionary interest in the last 10% of such oil in place? Surely, I. T. 4003 goes too far.

The sale of a long lived oil payment does not bear the slightest resemblance to a prepayment of rents. The seller has sold and the buyer has paid a substantial sum for a valuable, lasting and substantial mineral property. This property produces income in the hands of the new owner. The income received by the new owner is a depletion of the property interest he has bought. It is something that the seller never regains upon the termination of the interest sold. The sale is not a temporary assignment of the income from property; it is a completed sale of a very large number of the economic units in place, which are later extracted and consumed by the new owner.

I. T. 4003 was not adopted until 1950 (29 years after the adoption of the capital gain provisions).[33] Long established administrative practice, as well as all of the decided cases, are opposed to I. T. 4003. This past practice and these decisions have received implied legislative approval.[34] Any change in such accepted practice of such long standing should be made only by Congress. If this kind of mineral property, e. g., long term oil payments, are to be excluded from the capital gains provisions, Congress and not the Administrator should write the exception. I. T. 4003 is an attempt at administrative legislation.[35]

2. *The Problem of the Short-Lived Oil Payment Should be Left to Congress.*

If, as we believe, I. T. 4003 is clearly wrong, two alternatives are left: (1) To follow the letter of the statute and leave the curative work to Congress, or (2) to adopt the Insubstantial Transfer Rule. Of the two we submit, on constitutional grounds, the safest course is to follow the letter of the statute and let Congress handle the problem, if it deems it to be a problem. The point can best be tested by the isolated sale of a two year oil payment such as is referred

[33] And after its first test in the *Caldwell* case, the Government conceded that it went too far.

[34] As stated by the Court in *U. S. v. Leslie Salt Co.*, 350 U. S. 383, 396, (1956), "'Administrative practice, consistent and generally unchallenged, will not be overturned except for very cogent reasons if the scope of the command is indefinite and doubtful * * *.' Against the Treasury's long-standing and consistent administrative interpretation its more recent *ad hoc* contention as to how the statute should be construed cannot stand."

[35] For a searching analysis of this ruling, see "Assignments of Oil Payments" by Eugene Kunz, Professor of Law, University of Oklahoma, 31 Taxes, The Tax Magazine 863 (1953), who concludes that while there is a rational basis for G. C. M. 24849, there is no justification at all for I. T. 4003.

to in G. C. M. 24849,[36] if a taxpayer sells an oil payment (his entire interest) with a two year life, it is acknowledged that Congress intended capital gain. I. T. 4003, Can we be absolutely sure that Congress did not intend the same result on the sale of a carved out oil payment with the same life? The best evidence is that Congress, for right or wrong, did intend such short-lived oil payments to enjoy the 25% rate. This is drawn not alone from the all-inclusive phrase "mineral property" as used in the Committee Report, but from 25 years of administrative interpretation which has received legislative approval, *U. S. v. Leslie Salt Co. (Cited in footnote 36, supra)*. Congress did say that it intended "mineral property" sales to have the benefit of the 25% rate; nowhere has it said, or even intimated that certain types of mineral properties should be excluded. Nowhere has it suggested that the retention of a reversionary interest will deny capital gain treatment to that which is otherwise admittedly a capital asset.

Granted there may be an imperfection in the Code. There are many such imperfections. It might be admitted that we

[36]Here we are not referring to the "device" type of case, or to sales which are not bona fide. Nor are we referring to one such as the three-months oil payment involved in the Rudco case [*Rudco Oil & Gas Company v. U. S.*, 82 F. Supp. 746 (Ct. Cls., 1949)], nor to the case of a taxpayer who may, repetitively, sell oil payments for the obvious purpose of converting his current production into capital gain. Should any taxpayer be so bold as to claim capital gain in such a case, the Courts would promptly deny it on the ground that it was essentially the sale of current production; that the taxpayer had not changed his position; that the sale showed only a tax, not a business purpose; that it did not involve the hardship aimed at by the taxing statutes and that *Harmel* applies. What we are now dealing with is an isolated sale, extending substantially beyond the year, but one, nevertheless, that is small in relation to the reversion, such as a two year oil payment referred to in G. C. M. 24849. It would be expected that should the Court affirm all of these cases (the shortest payment being twenty-eight months in the *Weed* case), it would make it clear that such decision does not constitute approval of the use of oil payments to convert current production into capital gain.

would have a better statute if Congress had denied capital gain treatment to sales of relatively short-lived oil payments; or better still if it were to deny capital gain treatment to sales of all relatively short-lived oil properties, whether oil payments, leases or royalties. But the curing of such imperfections is for Congress. Congress has, since 1921, from time to time, added many amendments and exceptions to the capital gain provisions as experience develops imperfections. Today we have a very detailed statute and many exceptions to the general rule are spelled out.

Property held for less than six months (under the older revenue acts the holding periods varied) are excluded. So also is property held primarily for sale to customers, inventories, stock in trade. Special rules are provided in certain cases relating to copyrights, literary, musical or artistic compositions. [Sec. 117 (a) (1) (C).] If land is sold with unharvested crops thereon, a special rule is provided. [Sec. 117 (j) (3).] Sales of breeding animals are specifically denied capital gain treatment in certain instances. [Sec. 117 (j) (1).] Under Section 117 (m) sales of stock in a collapsible corporation are excluded. Special rules are provided in Sec. 117 (n) for sale of securities by dealers. Under Sec. 117 (o) sales of depreciable property between spouses or between a stockholder and a controlled corporation are denied capital gain treatment. Under Sec. 115 (g) redemptions of stock essentially equivalent to dividends are taxed at normal rates. This section also denies capital gain treatment where a subsidiary acquires stock in its parent controlled by the taxpayer. This latter rule was extended in the 1954 Code to the sale of stock in one corporation to another where the selling taxpayer controls both corporations. (Sec. 304, Internal Revenue Code of 1954.)

Likewise, Congress has drawn arbitrary lines in the matter of time and of percentages. Examples of arbitrary rules in point of time are: The six months holding period to qualify property for capital gains; the one-year holding period for livestock in a breeding herd; the five-year rule under the spin-off statute; the three-year under the collapsible corporation provisions; the two-year rule on gifts in trust for charity; the 10-year Clifford rule; the three-year (formerly two-year) contemplation of death rule; and the arbitrary time rules for qualified stock options.

Some examples of tax consequences dependent upon arbitrary percentages are: The 80% control test on contributions of property for stock; the 80% rule dealing with corporate reorganizations; the 5% reversionary interest rule in the estate tax on life insurance; the 5% reversionary interest on gifts to charity; the percentage limitations on charitable deductions; the 30% rule applicable to installment sales; and the arbitrary percentage rules governing the acquisitions of stock in loss corporations by purchase or reorganization.

The foregoing are but illustrative of the many situations in which Congress, in its judgment, has made tax consequences to depend upon some arbitrary rule, either in points of time or in terms of percentage.

even to the extent of saying that poultry shall not be regarded as a capital asset, but that a heifer raised for the breeding herd shall be, provided the heifer is twelve months old (but not eleven). Such articulation leaves little room for interpretation.

Tax laws, no less than criminal laws, should be clear and certain. When the question arises whether a particular business transaction bears a 25% rate or a 91% rate, the answer should be found in the plain language of the statute, written for the man on the street, and not in some nebulous theory drawn from an alien area of the tax laws.[38] If the language is plain it should be followed, even though we may dislike the result. If an amendment is desired, Congress, not the Administrator, should make it.

Our tradition, our constitutional system, as well as the necessity for the maintenance of a respect for the law so essential to the success of our voluntary assessment system, all suggest that legislation in this sensitive area of tax rates be left to Congress. So long as Congress sees fit to extend the 25% rate to the speculator in the stock market, we must not allow ourselves to become unduly agitated over a policy that taxes sales of "mineral properties" at the same rate. If this Court's choice lies between adopting I. T. 4003 on the one hand and applying the statute as written on the other; if the choice is between taxing all oil payments irrespective of life, at 91%, and taxing short term oil payments at 25%, we respectfully suggest that it is better that

[38] As said in *U. S. v. Leslie Salt Co.*, 350 U. S. 383, 397: "The words of the statute * * * are to be taken in the sense in which they will be understood by that public in which they are to take effect."

a few taxpayers enjoy a 25% rate than it is to adopt a rule that will tax a number of years of profits at 91%. Better to follow the letter of the statute than to produce a hardship that Congress sought to avoid in Sec. 117. Better that a few taxpayers enjoy a 25% rate than that this Court should legislate.

Undoubtedly the problem here calls for legislative, not judicial action. The first problem is where to draw the line in the case of sales of mineral properties of all types. Congress, after full Committee hearing and giving due regard to the interests of both the revenue and of the industry affected, is in a better position to draw the line than is the judiciary.[39] In addition, other related problems are involved. There is the matter of inter vivos family gifts of long and short-term oil payments, which involve policy considerations different from the capital gain question. Gifts to charity involve other and different policy questions. Then there is the need to protect and prescribe the rule relating to the development oil payments. Other and different policy considerations are involved in connection with the distribution of oil payments, long and short term, by oil corporations, either as ordinary dividends or in liquidation of a stock

[39]The language of the Court in *Radovich v. National Football League, et al.*, 352 U. S. 445, 452 (1957), is applicable to this situation:

> "We, therefore, conclude that the orderly way to eliminate error or discrimination, if any there be, is by legislation and not by court decision. Congressional processes are more accommodative, affording the whole industry hearings and an opportunity to assist in the formulation of new legislation. The resulting product is therefore more likely to protect the industry and the public alike. The whole scope of congressional action would be known long in advance and effective dates for the legislation could be set in the future without the injustices of retroactivity and surprise which might follow court action."

interest. Of great importance is the treatment to be accorded the oil payments in the A. B. C. transaction. Today hundreds of millions of dollars are represented in outstanding loans secured only by such oil payments.

It is respectfully submitted that the problem of the short-lived oil payment, with all of its ramifications, be left to Congress.

3. *Alternatively, the Court should Adopt the Middle Ground,—the Insubstantial Transfer Rule.*

If the Court should feel an impelling need to deal with the problem of the short-lived oil payment, pending action by Congress, then we submit its only alternative is to adopt the Insubstantial Transfer Rule advanced by the Government as its secondary argument.

Until Congress speaks it is, of course, impossible to draw a definite line between those oil payments that are long lived and those that are short-lived—between those that clearly represent a substantial property interest within the clear intent of Congress, and those that, because of their insubstantiality, give the feeling that they are but anticipations of future income. Professor Kunz has suggested that the line should be drawn somewhere between two and five years.[40] But, obviously, the Court will draw no definite line

[40] *Kunz*, op. cit., footnote 35 supra. There he says, "The Bureau's original position in G. C. M. 24849, that an interest of one or two years duration is a short lived interest, seems reasonable enough if a *Horst* doctrine is applied. At the other extreme, a five-year payment should clearly be considered as a long-lived payment, the five-year period usually being used as a rule of thumb to calculate the return of investment in valuing royalty interests. In between two extremes, who knows how long is long?"

at any fixed number of years. This would be legislation. If an arbitrary line is to be drawn, Congress must draw it. Nor should this Court permit itself to be forced into a position, on a case by case basis, of having to draw a fixed line.

However, pending congressional action, the Court could adopt the Insubstantial Transfer Rule and leave the question of whether a particular oil payment is substantial or insubstantial to the trier of the facts, to be determined in accordance with all the facts of a particular case.

The Insubstantial Transfer Rule takes note of the unique character of oil properties as being both a mineral property and at the same time the right to future profits. If the value of the interest sold is insubstantial in relation to the value of the interest retained, or if the estimated barrels of oil required to satisfy the oil payment are insubstantial in relation to the barrels which will thereafter remain to the seller, or the estimated period of pay out of the oil payment is insubstantial in relation to the estimated life of the property, or if a combination of these and other factors exist, then it might be held by the trier of the facts that the taxpayer has not sold a mineral interest within the intent of Congress but has merely anticipated future income. If the interest sold is insubstantial, it could be reconciled with the policy stated in the *Harmel* case to the effect that the situation does not "produce the kind of hardship aimed at by the taxing act." If, however, the interest sold is substantial, it cannot be regarded as, in effect, simply an anticipation of future profits, but must

be looked upon as a sale of a substantial part of the taxpayer's investment property within the intent of the Act, as outlined in *Harmel*. This would resolve the question in each case to one of degree.

The lower courts would in each case consider all relevant factors in an effort to arrive at a fair answer. They would consider in each case, the estimated life of the oil payment. If one or two years, they would follow G. C. M. 24849 and treat it as short term; but they would not necessarily be bound by the two year rule there suggested. One of a longer life might, under the circumstances, be considered short lived. They would consider its substantiality; and its relation to the reserved interest in an effort to determine whether it is, under the facts, a sale of a substantial and durable property interest, or an insubstantial one. They would consider whether under all the facts the transaction falls within the spirit of the capital gains law; whether to tax it, under the circumstances, at normal rates would "produce the kind of hardship aimed at by the capital gains provision." They would consider whether tax motives alone caused the sale or whether business considerations were predominant. They would consider even to whom the payment was sold, since a sale to the same pipe line company that purchases the daily production might, along with other factors, indicate that it is but a prepayment of future income. They would consider, among other things, whether the taxpayer has had a real change in position as a result of the sale; and whether the sale is out of but a small

fraction of his interest, or all, or a large fraction. No single factor would be controlling; all facts would be considered, and the trier of the facts would have the duty of determining, on the facts in each individual case, whether the particular payment is long or short; whether it is substantial or insubstantial.

This approach was adopted by the Court in the gift of income area in *Harrison v. Schaffner, 312 U. S. 579 (1941)*, where it said (at p. 583):

> "Unless in the meantime the difficulty be resolved by statute or treasury regulation, we leave it to future judicial decisions to determine precisely where the line shall be drawn between gifts of income-producing property and gifts of income from property of which the donor remains the owner for all substantial and practical purposes."

This same approach was applied in the capital gains area by the Second Circuit in *McAllister v. Commissioner, 157 F. 2d 235 (1946), cert. denied, 330 U. S. 826 (1947)*. There in allowing capital gain to the sale of a life estate,[41] the Court (at p. 237) said:

> "Setting the bounds to the area of tax incidence involves the drawing of lines which may often be of an arbitrary nature. But they should not be more unreal than the circumstances necessitate. Here the line of demarcation between the *Blair* and the *Horst* principles is obviously one of some difficulty to define explicitly or to establish in borderline cases. Doubtless all would agree that there is some distinction between

[41]The relationship of an oil payment to relatively short-lived oil property is comparable to the relationship of a life estate to a perpetual fee.

> selling a life estate in property and anticipating income for a few years in advance. It is the kind of distinction stressed in Harrison v. Schaffner, supra. * * * *The distinction seems logically and practically to turn upon anticipation of income payments over a reasonably short period of time and an out-and-out transfer of a substantial and durable property interest.* * *" Where the line should be finally placed we need not try to anticipate here." (Italics supplied.)

This was the principle that Judge Tuttle was reaching for in the *Hawn* case, supra, where he said:

> "If, in truth, a transfer of a part of future income merely puts in the transferee a right to collect such part of the total future income *as is insubstantial either in relation to the total amounts receivable or to the time during which it will be received*, such transfer does not make it the income of the transferee for tax purposes * * * we must determine whether such transfer is for a *substantial interest* in the total property owned by the transferor. Although it might be better if Congress provided the answer, in the absence of a congressional determination, it devolves on the Court to supply it."

The adoption of the Insubstantial Transfer Rule would, in effect, give recognition to G. C. M. 24849. It would thus give the revenues the protection sought by that ruling. At the same time it would avoid the legislation involved if I. T. 4003 were adopted.

If the Court should decide to adopt the Insubstantial Transfer Rule, we submit the proper disposition of these cases would be for the Court to lay down the guiding principles to be followed by the trial Courts and to remand these cases or some of them for a determination in light of such

principles. In leaving the question of substantiality to the lower Courts, this Court would be following the precedent set in *Helvering v. Clifford, 309 U. S. 331 (1940)*, and in *Commissioner v. Culbertson, 337 U. S. 733 (1949)*.

In the *Clifford* case, the Court was asked to announce the rules for determining whether an assignment in trust resulted in the retention of substantial or insubstantial rights in the donor and the Court established rules which served to guide the trial courts in future cases. In the *Clifford* case, the Court recognized that great weight was to be given the findings of the trier of facts as to the essential issues.

Also in the *Culbertson* case, which involved the family partnership question, this Court rejected the rule which had been adopted by certain trial courts; and in pointing out the error of the trial court it enumerated various factors which should be considered in arriving at the ultimate answer of whether a bona fide partnership was created. It remanded the case for a determination in accordance with the guiding principles so laid down. With the guiding set of rules thus announced in the *Culbertson* case, the trial courts have been able to work out the family partnership cases in fairness to the Government and the taxpayers. So in these cases, we feel, should the Insubstantial Transfer Rule be adopted, the best interest of both Government and taxpayers will be served so long as there is established for the guidance of the trial Courts the rules which should govern their findings. We have enumerated above many of the facts which we think the trial Courts should take into account in making their findings. Obviously, no

single fact such as the anticipated life of the oil payment should be controlling, but all facts must be considered. As in *Clifford* and *Culbertson*, the proper disposition of these cases is to lay down the guiding principles and leave it to the trier of the facts to determine whether the particular oil payment meets the test of substantially or whether it is so insubstantial as to be an anticipation of income rather than the sale of the type of "mineral interest" that Congress had in mind in enacting the capital gain provisions.

Should the Court adopt the Insubstantial Transfer Rule, it should (1) either remand all of the pending cases with the necessary instructions to the trial Courts to enable them to decide the questions at issue; or (2) remand only certain of the cases, for as we shall hereafter show, the District Court has made the essential findings in the *O'Connor* case and the decisions below in that case should be affirmed.

Part II

The Facts and Findings in the O'Connor Case

A.

The Taxpayers in the O'Connor Case Hold a Capital Asset and are Entitled to Capital Gain Treatment.

The Executors of the Estate of Thomas O'Connor sold the oil payment in question in order to raise funds to pay the balance due on Federal estate and State inheritance taxes, in a substantial amount. All of the stock, bonds, cattle, equipment and other assets of the Estate except its land and royalties had been sold to meet these taxes but a sub-

stantial deficit still remained. The executors did not wish to borrow money to meet the deficiency; they were anxious to close the Estate, discharge their obligations and distribute the remaining properties. Accordingly in November, 1948 they sold the oil payment in question and used the proceeds to pay the balance of Federal estate taxes, State inheritance taxes and Federal income taxes. The remainder of the proceeds ($165,000) was used for ad valorem taxes and administration expenses.

The sale was of all of their royalty, under existing and any and all future leases until the amount specified had been produced, saved and sold by the purchaser. It was the only sale of an oil payment ever made by the taxpayers.

The sale was bona fide and without a scintilla of sham or subterfuge. (R. 75, 76, 77.)

The cash consideration paid to the executors by the purchaser amounted to approximately $10,000,000. The basis of the oil payment in the executors' hands was approximately $2,000,000. The gain on the sale was approximately $8,000,000, and on this, at the capital gain rates of 25%, the taxpayers acknowledge a capital gains tax of approximately $2,000,000. The Government seeks an additional $3,600,000.

Considering the purpose for which the oil payment was sold,—to pay the balance of some $17,000,000 in death duties,—the taxpayers naturally feel rather strongly that the Government should be content with the $2,000,000 capital gains tax on this sale, and should not insist on an addi-

tional $3,600,000 unless the statute clearly requires such additional tax.

As indicated above, the statute does not clearly so provide. It allows capital gain on the sale of a "mineral property." The taxpayers sold a "mineral property." They sold, by a deed, duly acknowledged and recorded, all of their royalty, under existing and any and all future leases, until the amount specified in the deed had been produced, saved and sold by the purchaser. Thereafter, the buyer owned all of the royalty, produced it and sold the production, reported his income from the property, and paid tax on this income, less his cost depletion.

If this Court should adopt I. T. 4003 (the Government's primary contention) and hold that the sale of all carved out oil payments irrespective of life are normal income, then the decision below must be reversed. If the Court should accept our primary contention that the statute should be followed as written, leaving amendments to Congress, then the taxpayers win and the decisions below should be affirmed.

If, however, the Court should adopt the Insubstantial Transfer Rule (which is the Government's as well as our alternative position), then these taxpayers still win. Whatever remand is made of the other pending cases, the lower court has made all of the essential findings necessary to bring this case within the Insubstantial Transfer Rule, and remand in the *O'Connor* case is not called for. The *O'Connor* case was tried and decided on the basis that the Insubstantial Transfer Rule might possibly be the correct rule.

1. The sale was made in 1949. At that time G. C. M. 24849, supra, was in effect. It will be recalled that that G. C. M. reached "short-lived," as distinguished from "long-lived" oil payments, e. g., those referred to in the ruling that normally "pay out in one or two years." I. T. 4003, supra, extending the policy to all carved out oil payments, irrespective of life, was not promulgated until 1950, after the sale in question was made.

Judge Rice, the District Judge, specifically found (R. 77) "The property so sold was a long-lived, and not a short-lived, oil payment."[42] Thus, as the Court found, the sale satisfied all of the requirements of the Treasury rules in force when the sale was made. The Government does not challenge this determination of the Trial Court which was affirmed on appeal. Its contention is that its own ruling, in effect when the sale was made, was wrong; and despite full compliance with that ruling, its position now is that this sale should now be governed by a later ruling (I. T. 4003), representing a change in policy, which is given retroactive application.[43]

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[42]The oil payment paid out in three years of production, during which the properties were owned by Blackburn. The Court also found:

> "The oil payments would have taken an appreciably longer period to pay out had it not been for the fact that there was an increase in the production in the field by the operating lessees and had it not been for the further fact that there had been a substantial increase in the price of oil shortly prior to the sale, which higher price was maintained during the period of pay-out." (R. 76.)

[43]Since G. C. M. 24849 represents a change in policy, it was expressly made prospective only in its application, not applying to oil payment assignments made prior to April 1, 1946. I. T. 3895, 1948-1 Cum. Bull. 39. However, when the Treasury in 1950 shifted to the extreme position taken in I. T. 4003, no comparable provision for prospective application was published and that ruling is here being applied retroactively.

This phase of the Government's case is especially open to criticism. The Courts stand ready to protect taxpayers against retroactive legislation. Can they not protect taxpayers against retroactive administrative rulings, particularly where, as here, the ruling is itself open to a very serious question as to its constitutionality and validity? At the very least, we have here a very serious violation of principles of sound tax administration,—the observance of the rules of fair play,— which is so necessary to the maintenance of respect for the law and its administration.

In any event, if the Insubstantial Transfer Rule is adopted, the question of whether the carved out oil payment is long or short is an important factor and on this the trier of the facts has found that the oil payment in question is long-lived and not short-lived.

2. The District Court also found (R. 76):

> "The royalty interest (or oil payment) sold to Blackburn represented a substantial part of the plaintiffs' oil in place. Also, in terms of the relative values of the interest sold and of the reversionary interest retained by the sellers, the transfer represented a substantial part of the sellers' royalty interest."[44]

[44] The District Court's finding that the transfer represented a "substantial part of the sellers' royalty interest" is certainly justified by the facts—approximately 4,000,000 barrels of oil in place (R. 50) were sold at a price of about $10,000,000 (R. 48). The oil sold had a tax basis of $2,000,000 (R. 49), and a profit of $8,000,000 was realized. Oil in place is commonly valued at $1 per barrel, and so valued, the sellers' oil was worth approximately $23,000,000; thus in terms of value sellers sold nearly 50% of their oil. Considering the fact that salt water was encroaching on the field and that production was declining (R. 64), it is clear that taxpayers sold the cream of their properties. All of the foregoing figures clearly indicate that the oil in place sold was substantial, in terms of what the sellers owned, in terms of what the sellers retained, and in absolute terms.

Also the Court found: (R. 77)

> "The transaction was not intended to be and was not, as a matter of fact or as a matter of law, an assignment of income, but was the sale of a property interest to Blackburn, which property interest produced income in the hands of Blackburn. This property interest was substantial and real, representing a substantial part of the grantors' royalty interest."

In light of these findings, it is submitted that the District Court has made all of the essential findings necessary to bring this case within the Insubstantial Transfer Rule, should this Court decide to adopt that rule.

As we have earlier pointed out, the question of insubstantiality should be left to the trier of the facts. It has long been the view of this Court that conclusions of this type, involving opinions on the matter of degree, are for the trier of the facts.

As stated by this Court in *Bingham v. Commissioner, 325 U. S. 365, 370 (1945)*:

> "Ordinarily questions of reasonableness and proximity are for the trier of fact. * * * And even when they are hybrid questions of 'mixed law and fact', their resolution, because of the fact element involved, will usually afford little concrete guidance for future cases, and reviewing courts will set aside decisions of the Tax Court only when they announce a rule of general applicability, that the facts found fall short of meeting statutory requirements * * *."

The question of "insubstantiality" like questions of "reasonableness and proximity", should likewise be left to the triers of fact since they will usually afford little concrete

guidance for the courts in future cases; they do not involve "a clear cut question of law"; and do not involve "a rule of general applicability." See, *Commissioner v. Bedford, 325 U. S. 283 (1945).*

In *Graver Manufacturing Co., Inc. v. Linde Products Co., 339 U. S. 605, 609-610 (1950)*, this Court, in a patent infringement suit, held that:

> "What constitutes *equivalency* must be determined against the context of the patent, the prior art, and the particular circumstances of the case * * *.
>
> "A finding of equivalence is a determination of fact. * * * It is to be decided by the trial court and that court's decision, under general principles of appellate review, should not be disturbed unless clearly erroneous * * *." (Emphasis added.)

A finding of substantiality is, like a finding of equivalency or reasonableness, or of proximity, a question principally of fact and degree, and should be left to the lower courts. The question here is not whether this Court, sitting as a trier of the facts, might not have reached a different conclusion; it will sustain the lower courts unless clearly erroneous.

3. The District Court also found (R. 77):

> "The transaction was not intended to be and was not, as a matter of fact or a matter of law, an assignment of income. * * *
>
> "The property interest so sold to Blackburn was a capital asset as defined in Section 117 of the Internal Revenue Code of 1939, and this capital asset had been held by plaintiffs for more than six months.

> "None of the exceptions in Section 117 *or elsewhere in the Internal Revenue Code*, denying a transaction long term capital gain treatment, are applicable to the instant transaction."

The ultimate findings are entitled to finality here. Here we should quote the Government's own position taken from its reply brief in this Court in *Morris W. Zack v. Commissioner, No. 217, October Term 1957 (cert. denied, Oct. 14, 1957)*:

> "Whether particular property falls within the excepted category (property held by the taxpayer for sale to customers, etc.) presents a question of fact in each case, no single evidentiary factor being decisive, and the trial court's conclusion is entitled to affirmance unless clearly erroneous."

and

> "Both Courts below decided the factual issue against the taxpayer; their concurrent finding is entitled to finality here. *Corn Products Co. v. Commissioner*, 350 U. S. 46, 51; *Comstock v. Group of Investors*, 335 U. S. 211, 214."

And as this Court said in the *Corn Products* case, cited above:

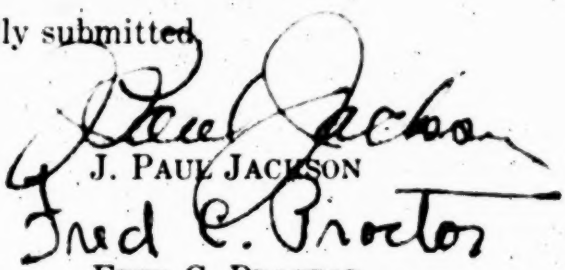
> "On essentially factual questions, the findings of two Courts should not ordinarily be disturbed."

CONCLUSION

It is respectfully submitted that this Court should leave the problem of the short-lived oil payment to Congress, in which event decision below in this case should be affirmed. Alternatively, the Court should adopt the Insubstantial Transfer Rule in which case the essential findings on sub-

stantiality have been determined by the two Courts below. Accordingly, this case should be affirmed even though the other cases now before the Court are remanded for findings on the question of substantiality.

Respectfully submitted,



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APPENDIX A

Statutes Involved

Internal Revenue Code of 1939

"SEC. 117. CAPITAL GAINS AND LOSSES.

[Sec. 117 (a)]

"(a) Definitions.—As used in this chapter—

"(1) Capital Assets.—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) Property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), or real property used in his trade or business;

(C) A copyright; a literary, musical, or artistic composition; or similar property; held by—

"(i) A taxpayer whose personal efforts created such property, or

"(ii) A taxpayer in whose hands the basis of such property is determined for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property; or * * *

"* * *

"(4) Long-Term Capital Gain.—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income;

[Sec. 117 (c)]

"* * * (1) * * * (2) * * *

"(B) There shall then be ascertained an amount equal to 25 per centum of the excess of the net long-term capital gain over the net short-term capital loss. In the case of any taxable year beginning after October 31, 1951, and before November 1, 1953, there shall be ascertained, in lieu of the amount computed under the preceding sentence, an amount equal to 26 per centum of the excess of the net long-term capital gain over the net short-term capital loss.

[Sec. 117 (f)]

"(f) Retirement of Bonds, Etc.—" * * *

[Sec. 117 (g)]

"(g) Gains and Losses from Short Sales, Etc.—" * * *.

[Sec. 117 (j)]

"(j) Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.—

"(1) Definition of Property Used in the Trade or Business.—For the purposes of this subsection, the term 'property used in the trade or business' which means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory

of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in subsection (a)(1)(C). Such term also includes timber or coal with respect to which subsection (k)(1) or (2) is applicable and unharvested crops to which paragraph (3) is applicable. Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

(2) General Rule.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets.

* * * * *

"(3) Sale of Land With Unharvested Crop.—In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged [or compulsorily or involuntarily converted as described in paragraph (2)] at the same

time and to the same person, the crop shall be considered as 'property used in the trade or business.'."

[Sec. 117 (k)]

"(k) Gain or loss in the Case of Timber or Coal.—"

[Sec. 117 (l)]

"(l) Short Sales, Etc.—" • • •.

[Sec. 117 (m)]

"(m) Collapsible Corporations—"

"(1) Treatment of Gain to Shareholders.—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset."

• • •.

[Sec. 117 (n)]

"(n) Dealers in Securities.—"

[Sec. 117 (o)]

"(o) Gain From Sale of Certain Property Between Spouses or Between an Individual and a Controlled Corporation—

"(1) Treatment of Gain as Ordinary Income.—In the case of a sale or exchange, directly or indirectly, of property described in paragraph (2)—

(A) Between a husband and wife; or

(B) Between an individual and a corporation more than 80 per centum in value of the outstanding stock of which is owned by such individual,

his spouse, and his minor children and minor grandchildren;

any gain recognized to the transferor from the sale or exchange of such property shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in subsection (j).

"(2) Subsection Applicable Only to Sales or Exchanges of Depreciable Property.—This subsection shall apply only in the case of a sale or exchange of property by a transferor which in the hands of the transferee is property of a character which is subject to the allowance for depreciation provided in section 23 (l)."

APPENDIX B

Tax Treatment of Various Oil and Gas Interests

I. *Lease*

An oil and gas lease is not a lease in the usual sense of the word. Under Texas law and under the laws of most oil producing states, it represents a horizontal severence of the minerals in place and a conveyance of seven-eighths (7/8) or other fraction thereof to the lessee by way of a determinable fee. The owner of the lease, whether he be the original lessee or an assignee of the lessee, is said to own the working interest or operating rights. This working interest carries with it the right, as well as the burden, of developing and operating the lease in question. The owner's interest in the lease and in the oil thereunder is real property. It is subject to all of the state laws relating to real property. The oil in the ground is an interest in realty and becomes personalty when it reaches the surface. Daily production of oil is ordinary income subject to the depletion allowance. However, the sale of the lease (or a fractional interest therein) is the sale of "property held for productive use in trade or business" and is entitled to capital gain treatment under Section 117 (j) of the 1939 Code, unless the taxpayer is a dealer in leases and the leases are held primarily for sale to customers in the ordinary course of his trade or business. *I. T. 3693, 1944. Cum. Bull. 272; Vern W. Bailey, 21 T. C. 678, 684, (1954); Walter A. Henshaw, 23 T. C. 176, 180 (1955).* The exchange of a

producing oil lease, held for productive use in trade or business or for investment, for fee interest in improved ranch to be held for productive use or investment, constitutes a tax-free exchange of property of like kind. *I. T. 4093, 1952-2 Cum. Bull. 130.*

II. *Bonus*

The bonus is the cash consideration paid by the lessee to the lessor for the determinable fee. It is purchase money under local law but is treated as advance royalty for income tax purposes. *Murphy Oil Co. v. Burnet, 287 U. S. 299 (1932).* As an advance royalty, the bonus is ordinary income to the lessor subject to the statutory depletion allowance. However, to the lessee, the bonus paid represents cost to the lessee and must be capitalized. The bonus may be paid in a lump sum or the lessee may pay the same in installments, in which event the lessor takes into income the payments when and as received by him. *Kleberg, 43 B. T. A. 277 (1941).* It has been held that if a lessor sells to a third party his right to receive future bonus payments, he has sold an advance royalty and is entitled to capital gain treatment on such sale. *Kleberg, 2 T. C. 1024 (1943); Cowden, 9 T. C. M. 1148 (1950).*

III. *Royalty*

Unlike the royalty customarily encountered in hardrock mineral leases, the oil and gas royalty is the retained ownership of the one-eighth (1/8) (or larger) interest in the oil or gas in place. The oil and gas in place is real property;

when it reaches the surface, it becomes personalty. The royalty owner owns the oil when it reaches the surface and sells it to a purchasing pipeline company. The pipeline company is an independent corporation or other organization, frequently a subsidiary of a major integrated oil company. The pipeline company purchases the oil at the wellhead and transports the oil to a refinery or other marketing outlet. Payment is made monthly to the seller of the oil, whether he be an operator, a royalty owner or other owner of oil in place. Since the oil in place is real property, the pipeline company's attorneys must examine the deed records of the county in order to be sure their company is remitting to the true record owner of the mineral estate.

Since the royalty interest is real property, it is governed by the laws of descent and distribution, by the laws of conveyance and recordation dealing with real property, and by the state ad valorem taxes affecting real property. For income tax purposes, the royalty interest is an economic interest in oil in place. Daily production is subject to normal tax treatment under *Burnet v. Harmel, 287 U. S. 103 (1932)*, subject to the depletion allowance. However, the royalty interest itself is a capital asset so that the sale of an entire royalty (or an undivided interest therein) is the sale of "property" and subject to capital gain treatment under Section 117 (a) of the 1939 Code. G. C. M. 12118, XII-Cum. Bull. 119 (1933), Rev. Ruling 55-526, 1955-2 Cum. Bull. 574; J. E. Murphy, 9 B. T. A. 610 (1927). The only instance in which capital gain is not allowed is where

the taxpayer is a dealer, buying and selling royalties, and is holding the property primarily for resale to customers in the ordinary course of such business. See *Darby Lynde Co. v. Alexander, 51 F. 2d 56 (10th Cir. 1931); Commissioner v. Fleming, 82 F. 2d 324 (5th Cir. 1936); Anna Taylor, 3 B. T. A. 1201 (1925); J. M. Hudson, 14 B. T. A. 983 (1928); R. R. Ratliff v. Commissioner, 36 B. T. A. 762 (1937); Greene v. Commissioner, 141 F. 2d 645 (5th Cir., 1944); P. A. Davis, 11 T. C. M. 704 (1952); J. E. Thompson, 7 T. C. M. 612 (1948).*

IV. *Overriding Royalty*

An overriding royalty is an additional royalty over and above the landowner's usual 1/8 royalty. The overriding royalty is usually created where a lessee or other owner of a lease "farms out" or assigns the lease to an assignee, retaining an additional fraction of the oil, if, as and when produced, as an overriding royalty, free and clear of all development and production expense. The overriding royalty is in all respects the same as the usual royalty; it is real property; an economic interest in oil in place; the receipts therefrom are normal income subject to depletion. However, a sale of an overriding royalty (or a fraction thereof) would be a sale of "property" and therefore the sale of a capital asset.

V. *Oil Payments*

An oil payment is often referred to as a "production payment" and more frequently referred to as a "limited overriding royalty." It is like a royalty in all respects ex-

cept that it is limited either to a specific number of barrels of oil in place or is measured by a specified sum of money. In the majority of cases, the oil or production payment is limited by a certain specified dollar amount. However, except for the limitation either in barrels or dollars, it is in all respects the same as a royalty. It is a specie of real property representing the ownership of a certain specified or ascertainable amount of oil in place; it is real property under the laws of Texas and most of the other states and subject to all of the state laws governing the devolution of real property at death, to the state recordation statutes relating to real property and to the state ad valorem taxes relating to real property. *Tennant v. Dunn, et al., 110 S. W. 2d 53 (Tex. Comm. of App. 1937); State v. Quintana Petroleum Co., 133 S. W. 2d 112 (opinion adopted by the Texas Supreme Court, 134 S. W. 2d 1016 (1940); State v. Whittenberg, 265 S. W. 2d 569 (1954).* It represents an economic interest in oil in place and consequently payments made to the owner with respect to the production attributable thereto is ordinary income subject, however, to the depletion allowance. *Thomas v. Perkins, 301 U. S. 655 (1937).* While all of it is income if held by the owner until extinction, a sale thereof in its entirety or of a fractional interest therein entitles the seller to capital gain treatment. G. C. M. 24849, 1946-1 Cum. Bull. 66; I. T. 4003, 1950-1 Cum. Bull. 10.

For a general description of various kinds of oil payments, see Trevathan, Federal Aspects of Oil Production Payments, 35 Taxes, The Tax Magazine, 179 (1957).

VI. *Reserved Oil Payment*

Customarily, in farming out an oil property, or in selling or assigning the same, the seller will retain an oil payment. See, *Thomas v. Perkins*, supra. Such a reservation, like the reservation of a royalty or an overriding royalty, is a reservation of a property interest or economic interest in oil in place. The income therefrom is the income of the holder of the reserved oil payment on which he is entitled to depletion. A subsequent sale of such reserved oil payment, in whole or in part, entitles the seller to capital gain treatment.

VII. *Development Oil Payment*

Oil payments are frequently given to a contractor as consideration or part consideration for the drilling of a well. It may be given to supply houses for the equipping of wells or to geologists or petroleum engineers, landmen, lawyers and others, to assist in the search for oil or in the development of oil properties. When so given, they are known as development oil payments. In such cases, no gain or loss is recognized on the exchange of the oil payment for the services of the geologists, or in exchange for a well, or in exchange for equipment on the well. The contractor or supply house receiving such an oil payment will capitalize the cost of the well or the cost of the equipment as the cost of the oil payment and obtain a recovery of such costs over the life of the oil payment through cost depletion or statutory depletion, whichever is greater. Similiarly, if an oil payment is sold and the proceeds thereof are ear-

marked or pledged for the development of oil properties, the oil payment is regarded as a development oil payment; and the sale is not recognized as a taxable transaction. The seller is not required to account as income for the cash so received which is pledged for development. *G. C. M. 22730, 1941-1 Cum. Bull. 214; I. T. 4003, 1950-1 Cum. Bull. 10; G. C. M. 24849, 1946-1 Cum. Bull. 66; Rawco, Inc., Ltd., 37 B. T. A. 128 (1938); Trans-California Oil Company, Ltd., 37 B. T. A. 119 (1938); Vern W. Bailey, 21 T. C. 678 (1954).* If; however, an obligation to the drilling contractor or to a supply house is created prior to the creation of the oil payment, and the oil payment is given in satisfaction of such fixed obligation, then the obligation will be considered to have been discharged by the granting of the oil payment; the taxpayer will be considered to have disposed of an asset in satisfaction of an obligation, thereby realizing taxable gain. If the purchaser, contractor, supply house or other person has acquired a development oil payment and holds the same to extinction, all of it would be income in such owner's hands, subject to normal taxation and subject, however, to percentage or cost depletion. But if such owner were to sell the oil payment or sell a fractional interest therein, he would be entitled to capital gain treatment.

VIII. *Guaranteed Oil Payment*

If one grants a development or other type of oil payment and guarantees to the holder thereof that the oil payment will pay out, then he has created an obligation, which

obligation is satisfied as the oil payment pays out. Under such circumstances, the obligor is taxable on the income from the oil payment in the hands of the obligee. *C. F. Anderson v. Helvering, 310 U. S. 404 (1940); Delacroix Corporation, 13 T. C. 827; 839 (1949); Charles Burke, 5 T. C. 1167 (1945); Refiners Production Co., 43 B. T. A. 481, 494 (1941).*

IX. *Carved Out Oil Payment*

An oil payment is said to be "carved out" when it is created from a larger oil interest. It may be carved out of a royalty interest or a leasehold or working interest or out of a larger oil payment. It may be "carved out" and retained on a farmout transaction or "carved out" and given as a development oil payment. When a carved oil payment is sold for cash or other valuable consideration, the purchaser has, as his cost, the consideration paid therefor; he has an economic interest in oil in place; and his income with respect to the oil payment is ordinary income; and upon sale he is entitled to capital gain. However, the Government's present position is that the seller of a carved out oil payment (other than a development oil payment) has sold income and is denied capital gain treatment.

X. *Interest-Bearing Oil Payment*

As stated above, the oil payment is limited either by a specified amount in dollars or by a specified number of barrels of oil. More frequently, it is measured by a dollar

limitation. With the increasing use of development oil payments and with the increasing popularity of the A-B-C transaction hereinafter described, the interest-bearing oil payment has attained widespread use. The interest factor in an interest-bearing oil payment is not interest in any true sense; it is simply a measuring stick to determine the additional quantity of oil in place represented by the oil payment. The interest-bearing oil payment gives to the holder thereof the ownership of an economic interest of a quantity of oil in place measured by the face amount specified in the payment, together with an additional amount equal to what would be interest on such face amount calculated on declining balances. Typically, also, the oil payment will specify that the holder will own, free of lifting and development costs, a quantity of oil which will produce to the holder, free of cost, an additional amount equal to any ad valorem tax or gross production tax attributable to such oil payment. Here again, like the interest factor, the provision giving to the holder an amount equal to ad valorem and production taxes is but a yardstick to determine the extent of the holder's interest in oil in place.

XI. *The A-B-C Transaction*

The A-B-C transaction involves the use of oil payments in connection with the sale of productive property. While these transactions vary in detail, the following example will illustrate the typical type of A-B-C deal. A, the owner of a producing lease, desires to sell the same for $1,000,000.

He enters into a three-way transaction with B and C. He sells the working interest or lease to B for $500,000 in cash and retains or reserves an oil payment payable out of 80% of the production in the face amount of $500,000, bearing interest on declining balances at 6% per annum. Simultaneously, or immediately thereafter, he sells his retained oil payment to C for $500,000 in cash. C borrows $500,000 from the bank, putting up the $500,000 oil payment as collateral, and the bank charges him 5% interest. In this transaction, A, the seller, has sold all of the property he owns in two transactions: (1) the working interest to B, burdened with an oil payment, for $500,000; and (2) the oil payment to C for $500,000, thus realizing the $1,000,000 asking price. On this transaction, A obtains capital gain treatment. B, who has acquired the working interest, acquires the same burdened with the oil payment, and B is not taxed on the 80% of production going to C, to retire the oil payment. B pays tax during the payout of the oil payment only on the 20% of the production, against which he may expense his lifting and development costs. C is taxable at ordinary rates on the income from the $500,000 oil payment, but since he has a $500,000 cost, his taxable income is simply the difference between the 6% interest factor in the oil payment and the 5% interest that he pays to the bank.

Most sales of producing properties today are made by and through the means of the A-B-C transaction above described, or some variation thereof. If the transaction is

bona fide and there are no guarantees of the oil payment by either A or B, the transaction will be recognized by the Treasury Department and the tax results described above will be recognized. Neither A nor B will be deemed to have sold a carved out oil payment and neither of them will be deemed to have assigned or sold income to C, the purchaser of the oil payment.

Many rulings have been granted on these transactions and these transactions are recognized by the Treasury for tax purposes.

On the use of the A-B-C transaction, see Welsch, Acquiring Oil Properties Through Oil Payments and Related Methods, 32 Taxes, The Tax Magazine 494 (1954).

XII. *The Carried Interest*

The carried interest involves a specie of oil payment. Typically, the transaction would be as follows: A is the owner of a producing oil property; he desires the property to be further developed but does not have the funds to drill the additional necessary wells. B is willing to develop the property and to allow A to retain an interest. A thereupon assigns the lease to B, absolutely and in its entirety. B commits himself to drill the necessary development wells at his sole cost and expense. B pays to A $100,000 in cash for the proven lease and, in addition, agrees that after he, the assignee, has from 100% of the production obtained a recovery of his $100,000, plus an amount equal to all costs of development, plus an amount equal to all costs of operat-

ing, that thereupon a one-half (½) interest in the lease will revert to A. In this type of carried interest or carried working interest, A is being carried for a half interest. The tax consequences are that during the payout period, B who is the pro tem owner of the lease, is entitled to all of the income and will be taxed on all of the income from the property subject to the depletion allowance; B as the pro tem owner of the working interest, would be entitled to charge off all the intangibles incurred in the drilling of the wells and would likewise be entitled to deduct all of the operating expenses as well as the depreciation on the equipment installed in the wells. Since A has only a reversionary interest, he is not taxed during the payout period nor does he get the benefit of the intangibles or other deductions. After the payout, the parties are 50 50 owners of the property and thereafter share annually the income, deductions and expenses. A is not taxed on the value of the interest when it reverts since he has owned that interest throughout.

Despite the fact that A has sold the property subject to a reversionary interest in himself, he is nevertheless deemed to have sold a capital asset and consequently will have the benefit of capital gain treatment on the $100,000 of cash paid to him by B on the assignment of the lease. The existence of the reversionary interest in A does not deprive him of his capital gain treatment under current Treasury practice.

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No. 108

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Petitioner,

v.

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v.

P. G. LAKE, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR WM. FLEMING, ET AL and P. G. LAKE, INC.

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BRIEF FOR WM. FLEMING, ET AL and P. G. LAKE, INC.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court in the *Fleming* case (R. 142-155) are reported at 24 T.C. 818. The opinion of the Court of Appeals (R. 180-189) is reported at 241 F. 2d 78.

The opinion of the Tax Court in the *Lake* case (R. 13-14) is reported at 24 T.C. 1016. The opinion of the Court of Appeals (R. 16-27) is reported at 241 F. 2d 71.

JURISDICTION

The judgments of the Court of Appeals in these two cases were entered on February 1, 1957 (*Lake* case, R. 27; *Fleming, et al*, R. 190). The petition for a writ of certiorari was filed April 17, 1957 and was granted June 3, 1957. The jurisdiction of this Court rests upon 28 U.S.C. Section 1254.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 and Treasury Regulations are set forth in Appendix A hereto, *infra* pages 72-83. They are as follows: Sections 23(m) 112(a) and (b)(1) 114(b)(3); and 117(a)(1)(4)(8)(10)(b)(c) and (j)(1)(2); and Sections 39.23(m)-1(a)(b) and (e) and 39.112(b)(1)-1 of Treasury Regulations 118.

QUESTIONS PRESENTED

The *Fleming Case* presents two questions:

(1) Each of the taxpayers (respondents) in the *Fleming* case was engaged in the business of producing oil and had owned for a period of years various interests in commercial producing oil and gas leases and producing oil royalty interests, holding these for productive use in business. In 1948, one group of these taxpayers carved limited overriding royalty or oil payment interests out of several of these leaseholds and one royalty interest, and conveyed them to a third person in exchange for ranch lands and as the sole consideration therefor. In 1949, another of these taxpayers, having owned for a period of years for productive use in his business, commercial oil and gas leases, carved limited overriding royalty or oil payment interests out of some of these leases and conveyed the carved-out interests to a third person in exchange for urban real estate and as the sole consideration therefor. In each case, the taxpayers acquired and held for investment the real estate they received in these exchanges.

The first question is, whether the court below was correct in holding that these exchanges were of properties of like kind within the purview of Section 112(b)(1), Internal Revenue Code of

1939, so that no gain or loss is to be recognized for tax purposes because of the exchange.

The second question, to be reached in the *Fleming* case only if the holding of the court below on the non-taxable-exchange question is reversed, is whether the gain resulting to the Fleming group from the said exchanges is to be taxed as long-term capital gain or as ordinary depletable income from the properties from which the oil payments were carved.

The *P. G. Lake, Inc.* case presents only the second question involved in the *Fleming* case. The taxpayer (respondent was engaged in the business of producing oil. In 1950, it assigned to its president, a limited overriding royalty or oil payment interest out of two commercial oil and gas leases (which it had owned for several years), in satisfaction of an indebtedness then owing by the taxpayer to him, and reported the gain resulting from this transaction as long-term capital gain. This treatment was upheld by the court below. The question is whether this holding is correct, or the gain represented ordinary depletable income from the leaseholds out of which the oil payment interests were carved and conveyed.

STATEMENT

Both cases originated in the Tax Court as the result of deficiency determinations to the effect, in the

Fleming case, that the exchanges gave rise to recognized gain taxable as ordinary income with an allowance for percentage depletion; and in the *Lake* case, that the gain was not taxable as long-term capital gain but was taxable as ordinary income with a similar allowance for percentage depletion. The Tax Court upheld the Commissioner's determination on the nontaxable-exchange question in the *Fleming* case, but held that the gain was taxable as long-term capital gain. It reached a similar conclusion on the capital-gain issue in the *Lake* case. On petitions for review, the court below held in the *Fleming* case that both exchanges came within Section 112(b)(1) of the Internal Revenue Code of 1939, so that no gain was to be recognized therefrom, and then stated:

> "If we assume that we are in error in this view, and we, therefore, reach the third issue (capital-gain issue) * * * raised on the Commissioner's appeal, that the Tax Court erred in holding that the transactions were exchanges of property giving rise to capital gains treatment and not anticipatory assignments of income, we find ourselves in agreement with the Tax Court, and for the reasons set out in *Scofield* v. *O'Connor* and *Lake* v. *Commissioner*, this day decided, we affirm its judgment on this issue." (R. 187)

The Court below affirmed the Tax Court on the capital-gain issue involved in the *Lake* case.

All pertinent facts in each case were stipulated. The basic facts in these cases as summarized in pe-

titioners' brief (*Fleming* case, pp. 8-11; *Lake* case, pp. 5-6) are accurately stated, but there should be considered in connection therewith the following stipulated or undisputed facts:

The oil-payment conveyance from Fleming Oil Company to Mrs. Cline (the ranch owner) (R. 167-170), provided in part (R. 168):

> "Now, therefore, * * *, the undersigned, Fleming Oil Company, * * *, does hereby sell, assign and convey unto the said Mrs. Marie Hildreth Cline, * * *, the following-described real property, to wit:
>
> "An overriding royalty or mineral interest carved hereby out of the interest owned by Fleming Oil Company in each and all of the oil and gas leases described above, amounting to an undivided 49 128ths interest in and to all the oil in, under or that may be produced, saved and marketed from the above-described tracts of land, under the terms of the oil and gas leases covering the same, until the grantee named above shall have received therefrom oil of the net value of One Hundred Forty-Seven Thousand Dollars ($147,000.00), plus an amount equal to five per cent (5%) interest per annum from May 1, 1948, on the portion of said $147,000.00 which may be unsatisfied from time to time."

The instrument excluded from the interest conveyed gas or casinghead gas, as well as oil well

equipment, freed the interest conveyed from all costs of developing and operating the property, and the assignor from any express or implied obligation to see that the grantee received oil of the value specified and closed with the ordinary general warranty clause used in conveyances.

The other conveyances to Mrs. Cline (R. 170, 172, 175) were in substantially similar terms, as was the 1949 conveyance from Walsh to Cross, the owner of the urban property conveyed to Walsh (R. 177).

It was stated in the stipulation (R. 161) that:

> "On May 19, 1948, in accordance with a pre-existing agreement so to do, an exchange was consummated between Fleming Oil Company * * * on the one hand, and Marie Hildreth Cline on the other, by which Fleming Oil company * * * were conveyed by the said Marie Hildreth Cline * * * the fee simple title to some 2,994.5 acres of land * * * then used and suitable for ranching purposes. As the sole consideration for said conveyance, Fleming Oil Company assigned and conveyed * * * the limited overriding royalty or oil payment interests herein more fully described. These limited overriding royalty or oil payment interests came from oil and gas leases or oil and gas mineral interests, which the respective transferors had held and owned for considerably more than six months prior to the date of said transaction—May 19, 1948—for productive use in their respective trades and businesses and not for sale.

> The said ranch so acquired in said exchange by Fleming Oil Company, Wm. Fleming Trustee and Wm. Fleming was acquired by them, and each of them, for investment, and has been held for investment and not for sale, since said acquisition."

The stipulation contains a substantially similar statement as to the Walsh-Cross transaction (R, 165-166).

The oil-payment conveyance in the *Lake* case (R. 8-10), after reciting the ownership by P. G. Lake, Inc. of two oil and gas leases, continued (R. 9):

> "That P. G. Lake, Inc. * * * for and in consideration of the sum of Ten Dollars ($10.00) and other good and valuable consideration to it in hand paid by P. G. Lake * * * does hereby barbain, sell, assign and convey unto the said grantee, his heirs and assigns, such an interest in said oil and gas leases, and each of them, so that the said P. G. Lake, grantee, shall own twenty-five per cent (25%) of seven-eighths (7/8ths) of all oil and gas in, under or upon such leases and each of them, and shall be entitled to receive twenty-five per cent (25%) of seven-eighths (7/8ths) of all the oil, gas and other minerals produced, saved and marketed from the above-described oil and gas leases and leasehold estates, from and after 7:00 a.m. January 1, 1951, until said grantee, his heirs and assigns shall have received by virtue of this interest the sum of Six Hundred Thous-

> and Dollars ($600,000) net to him after the payment of all pipe line and gross production taxes attributable to said interest, plus an amount equal to interest at the rate of three per cent (3%) per annum, payable monthly on the entire unpaid balance of said original sum remaining from month to month unsatisfied."

It was then provided that the interest assigned should be free and clear of expenses of developing and operating the property, and grantor was to hold grantee harmless therefrom, and then stated (R. 10):

> "The parties hereto shall from time to time execute such transfer orders, division orders and instruments of like character necessary in order to carry into effect the terms and provisions of this conveyance and to facilitate the orderly handling, transportation and sale of the oil and gas produced from said leases."

This was followed by a provision that the interest conveyed was to terminate when the amount specified had been received by the grantee.

It was stipulated further (R. 10):

> "Following the execution and delivery of the instrument set out in the preceding paragraph by petitioner by P. G. Lake, transfer orders in the usual form were executed and delivered to the pipe line companies which were then running and purchasing the oil produced from the said properties, directing the payment to P. G. Lake of the

proceeds from the sale of twenty-five per cent (25%) of seven-eighths (7/8ths) of the oil and gas produced from said Reid and Owens leases, effective at 7:00 a.m. January 1, 1951, until he, the said P. G. Lake, had received oil and gas of the value specified in said instrument above set forth. In accordance with this order, the pipe line companies purchasing said oil and gas paid P.G. Lake directly for said share of the oil and gas, beginning with oil and gas produced during the month of January, 1951, and continuing until February, 1954, at which time the said P. G. Lake had received oil and gas of the value specified in the foregoing instrument."

SUMMARY OF ARGUMENT

I.

The oil payment assignments made by the Flemings and P. G. Lake, Inc. were conveyances of present interests in real property, not assignments of future income, because:

(a) The oil payments were part of, and carved out of the grantors' leasehold and royalty interests, everywhere recognized as real property;

(b) Such oil payment interests are likewise recognized as interests in real property;

(c) Each oil payment grantee acquired by investment a depletable economic interest in the real prop-

erty (oil reserve) owned by his grantor. This was true present ownership for the grantee could look only to oil when, as and if produced to recover his investment; the loss or destruction of the pertinent oil reserve without fault on the part of anyone would fall solely on the grantee; he, and he alone, could dispose of the interest by sale, exchange, gift or otherwise as he saw fit without liability to account to anyone; and it could be taken for the debts of grantee and not for those of any other person;

(d) The oil applicable to any of the oil payment interests was the income of the oil payment grantee when produced. This is evidence of true ownership because only the owner of property is taxable on its income.

(e) The oil payment assignee, and he alone, is entitled to an allowance against the oil payment income, because he alone has the requisite economic interest therein. This economic interest is actually ownership, whether evidenced formally as here, or informally as was true in some of the cases decided by this Court. Such depletion allowance is not available to one whose interest attaches to oil only after it is produced.

(g) Petitioners' theory of "assignment of future income" disregards the unique character of oil and other mineral holdings and tax principles long established by decisions of this Court.

II.

The Fleming exchanges of oil payment interests for lands were admittedly within the "non-recognition of gain or loss" provisions of Section 112(b)(1) I.R.C. of 1939, if the properties exchanged were of "like kind" as that term is used in this section.

The properties exchanged, though of different grades and qualities, were of the same nature and character in that both were realty. This, under regulations continued in force since 1921, is all that is required. The Courts have on several occasions expressly approved these regulations; Congress has at least inferentially done so by repeatedly reenacting the statutory provision without change.

The Court below is the only Appellate Court that has considered the precise problem. That Court has held Louisiana mineral interests and urban property, as well as a carved out oil payment and a landowner's mineral interest, to be properties of like kind, in addition to the holding here under consideration.

The Treasury has ruled that an exchange of an oil lease for land, as well as the exchange of a pepetual

water right for land, were exchanges of properties of like kind under Section 112(b)(1). These rulings reenforce the correctness of Fleming's position and the holding of the Court below.

III.

The Treasury's present position as to the proper method of taxing the gain from the disposition of carved-out oil payments is a complete reversal of its long-continued practice which had received judicial and congressional approval. This practice has thereby been so deeply embedded in the law that it could not be changed administratively.

Until 1946, the disposition of a carved-out oil payment of any duration (if other statutory requirements were met) was held to produce long-term capital gain. A ruling issued in that year attempted to exclude from this rule short-lived oil payments (those ordinarily having a duration of one or two years), but this ruling was not applied retroactively. A 1950 ruling attempted to bring all carved-out oil payments within the 1946 rule as to short-lived ones.

There had been no pertinent change in the capital gain provisions as repeatedly reenacted in various Revenue Acts, and the principle that the sale of a carved-out oil payment was a sale of an interest in the property and not productive of ordinary depletable income had been judicially determined.

The oil payments now under consideration were not "short-lived" but had durations of from more than three to twelve years.

The Treasury's "about face" is administrative legislation—forbidden by the doctrine of *U. S.* v. *Leslie Salt Company*, 350 U.S. 383.

Since the Fleming transactions were fully consummated in 1948 and 1949, before the 1950 adminstrative attempt to do away with the distinction between short-lived and longer oil payments was made, the Commissioner's action as to them had the added, and very serious, vice of retroactivity.

IV.

The taxpayers' conveyances meet every statutory requirement for long-term capital gain treatment of the resulting gain. Each came from, and was a part of, property which the grantor had held for productive use in his business for the requisite length of time. The statutory exceptions (stock in trade, etc.) are not applicable. Each transaction was a sale or exchange of a present interest in the property, not of oil after it had been produced or of future income.

This accords with all holdings of the Tax Court and of all of the Appellate Courts which have passed upon the question, except that in *Commissioner of Internal Revenue* v. *Slagter*, 238 F. 2d 901 (USCA 7th), the

correctness of which petitioners expressly disavow,—with principles announced by this Court, and general and local law on the subject.

V.

Petitioners' theories cannot be reconciled with the principles governing the allowance of depletion firmly established by decisions of this Court. Each oil payment conveyance vested a depletable economic interest (ownership) in the oil reserve in its grantee. Depletion on the oil payment yield to grantee cannot be denied. Such an allowance cannot be made to one whose rights in the oil attach only after production. Depletion is not allowable with respect to proceeds from the sale of an interest in property as distinguished from income from production. The determination of who has an economic interest (ownership) in an oil reserve controls both who reports the income from the interest and who is entitled to depletion with respect thereto. The two concepts are inseparable. Depletion cannot be allowed on more than 100% of the gross income from the production of a property.

Petitioners' theories violate all of these principles, in that, under them, depletion is allowed on the proceeds of a sale, and since depletion cannot be denied to the oil-payment grantee, the necessary result is an allowance for depletion on more than 100% of the gross income from the property.

VI.

The long-continued and admittedly correct tax treatment of similar transactions such as sales of leases with the retention of an oil payment, the carving-out and sale of unlimited overriding royalties, the sale by the retainer or grantee of any oil payment, and the re-allocation of the depletion required by such transactions, establishes the incorrectness of petitioners' position here.

These practices establish that a lessee's interest in an oil reserve can be divided between either an unlimited overriding royalty or an oil-payment interest and the remainder of the working interest; that each part continues to be a depletable economic interest and a capital investment; and that sales of any of these interests, except that now in dispute, that is; one accomplished by the carving-out of an oil payment, produce long-term capital gain if other statutory requirements are met.

There is no practical or legal basis for these distinctions. If the carving-out and sale of an oil payment is only an assignment of future income, so is the carving-out and sale of an unlimited overriding royalty. If one conveys a depletable economic interest, so does the other. If the carving-out and sale of an oil payment merely give the grantee the right to collect for grantor's oil, the reservation of such an oil payment in the sale of a lease merely gives the assignor the right to collect for assignee's oil.

The distinctions urged by petitioners are wholly arbitrary and unsound.

VII.

Petitioners' arguments are unsound. Contrary to these arguments:

(a) Each oil-payment grantee made the requisite capital investment;

(b) Each oil payment was a sale or exchange of income-producing property;

(c) By each oil-payment conveyance, its grantor realized on the increase in value of his capital investment;

(d) Each oil-payment interest conveyed was substantial;

(e) Each transaction was a sale, not a leasing transaction to which *Burnet* v. *Harmel*, 287 U.S. 103, applies;

(f) The "donative assignment of future income" cases are inapplicable;

(g) The Lake transaction cannot be treated as a debt payment with cash, nor can the Fleming transactions be treated as purchases for deferred cash payments; but if they could, neither petitioners' nor tax-

payers' position would be right, but the *Slagter* doctrine, disavowed by petitioners, would be applicable, and substantially all of the resulting income would be taxable in years other than those before the Court.

ARGUMENT

I.

The oil payment assignments made by the Flemings and P. G. Lake, Inc. were conveyances of present depletable interests in real property, not assignments of future income.

We are here dealing with ordinary commercial oil and gas leaseholds and, in one case, with an ordinary royalty interest. Such interests have always been, and are now, recognized as interests in real estate by the decisions of this Court,[1] by local law and decisions,[2] by all of the tax cases dealing with the subject,[3]

[1] *Waggoner Estate* v. *Wichita County*, 273 U.S. 113; *Thomas* v. *Perkins*, 301 U.S. 655.

[2] *Tennant* v. *Dunn*, 130 Tex. 285, 110 S.W. 2d 53; *Sheffield* v. *Hogg*, 124 Tex. 290, 77 S.W. 2d 1021; *Stephens County* v. *Mid-Kansas Oil & Gas Company*, 113 Tex. 160, 254 S.W. 290; *W. T. Waggoner Estate* v. *Sigler Oil Company*, 118 Tex. 509, 19 S.W. 2d 27. Particularly pertinent is the holding in *Tennant* v. *Dunn*, *supra*, extensively analyzed and commented upon by Judge Hutcheson in his opinion in the Lake case, R. 19-22, 23, 24, 25. Judge Hutcheson's long experience as a Texas lawyer and as a United States District Judge in the Southern District of Texas before he went to the Bench of the Fifth Circuit, where all types of cases involving oil and

and by Treasury administrative practices and rulings.[4] Such interests are property within the purview of *Section 117*, Internal Revenue Code of 1939, and are not excluded from the meaning of the term "property" as there used by any of the excepting provisions of said section.[5]

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gas were continually coming before him for consideration, gives added weight to his pronouncement on any phase of Texas Oil and Gas Law.

[3]A large number of Appellate Court tax cases are collected and summarized in Appendix C hereto, pp. 135 to 152, infra. See particularly *Fleming* v. *Commissioner*, 82 F. 2d 324, infra p. 147; *Ortiz Oil Company* v. *Commissioner*, 102 F. 2d 508, infra p. 138; *Commissioner* v. *Rowan Drilling Company*, 130 F. 2d 62, infra p. 145.

[4]Some of the pertinent administrative rulings are reproduced in full in Appendix B hereto. That the interest of a lessee in an oil and gas lease is real property is expressly held in *I.T. 3693*, infra p. 112-115, and other rulings reproduced in Appendix B hereto proceed upon the same theory.

[5]The definitions of "property" and "capital asset" contained in earlier revenue legislation dealing with the taxation of capital gains are modified in the Internal Revenue Code of 1939 (applicable here) to exclude from the definition of "property" contained in *Section 117(a)* of that Code, Appendix A infra, p. 74, "real property used in his trade or business", but *Section 117(j)* of the Code expressly allows capital gain treatment where gains are derived from the sale of "real estate used in his trade or business" but allows losses from such sales or exchanges to be treated—within certain limitations—as ordinary losses. So, since no losses are involved in the present cases, it is immaterial whether the taxpayers' oil interests be treated as property under *Section 117(a)* or as real property used in trade or business under *Section 117(j)* *I.T. 3693*, Appendix B, p. 112 infra, is to the same effect. The other exceptions to the definition of

Petitioners cannot, and we are sure will not, deny that the sale by any of the Fleming taxpayers or by P. G. Lake, Inc. of any of the properties to which the oil payment conveyances here involved relate, or an undivided interest in any such property continuing for the entire life of the property, would have produced long term capital gain taxable as such under said Section 117.*

Each conveyance involved in the Fleming and Lake cases was a conveyance of a true oil payment interest in the property to which the conveyance related,—that is, it gave to the assignee a right to a specified share of oil when, as and if produced, free of cost of developing and operating the property, and required the assignee purchaser to look only to the specified share of oil when, as and if produced for the recovery of his investment. Such an interest differs from an unlimited overriding royalty only in that it will not necessarily continue for the economic life of the property, but will terminate when, as and if the specified quan-

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capital assets contained in *Section 117(a)(1) I.R.C. 1939*, Appendix A, p. 74, infra, (stock in trade, inventoriable property, property held primarily for sale to customers, property used in business of a character which is subject to the allowance for depreciation, a copyright, etc., and certain obligations of the United States or its Possessions, or of other governmental agencies) are clearly not applicable.

*I.T. 3693, Appendix B, p. 112 infra. By stipulation each such property had been held for the requisite time and was held by its owner for productive use in trade or business and not for sale to customers. R. 8, 162, 166.

tity of oil, or oil of the specified value, has been produced for the account of its owner.

Further it is clear that the owner of an oil payment interest has a depletable economic interest in the property to which his oil payment relates. The decisions of this Court beginning with *Palmer* v. *Bender*, 287 U.S. 551, and continuing through *Commissioner* v. *Southwest Exploration Company*, 350 U.S. 308, conclusively establish that everyone who acquires by investment a right to share in oil when, as, and if produced for the recovery of his investment, has a deplet-

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[1]This has been the consistent view of the Internal Revenue Service. See *I.T. 4003*, Appendix B, p. 125 infra. Even in *G.C.M. 24,849*, Appendix B, p. 117, infra, which attempted to deny capital gain treatment to gain derived from the sale of a short-lived oil payment, it was recognized that the one acquiring the oil payment interest acquired a depletable economic interest in the oil and gas in place, see p. 119 infra. The statement in the petitioners' brief (footnote 17, p. 37) that: "It should be noted that, even if the assignments did convey an economic interest in the oil in place, the assignees would be entitled to depletion only on the excess of the oil payments over the amount paid for the assignments" is directly contrary to the long-continued and present practice of the Internal Revenue Service. This error has been called to the attention of petitioners' counsel and we are sure that at or before the argument counsel will admit that the statement is erroneous. The correct practice is to allow the oil payment holder depletion based upon cost or upon 27-1/2% of the oil payment holder's gross income from the oil payment, whichever produces the larger deduction, but not to allow recovery of cost (cost depletion) and then percentage depletion upon the excess over cost. This would be a double depletion deduction. See also, argument at page 55, infra.

able economic interest in the oil property. Further, this Court has expressly held that the same criteria which determine who is entitled to depletion with respect to oil produced determine who is the owner of the corresponding interest in the property. In *Anderson* v. *Helvering*, 310 U.S. 404, this Court said (Page 407):

> "It is settled that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable. That issue is, who has the capital investment in the oil and gas in place and what is the extent of his interest."

See, also, *Burton-Sutton Oil Co.* v. *Comm.* 328 U.S. 25.

The interest of an oil payment holder in the oil and gas reserve is a true ownership. One owns property of the loss from the destruction of the property without fault would fall entirely on him. One owns property if it can be taken for his debt and for that of no other person. One owns property if he has the power to dispose of it without liability to account to anyone. The rights of the grantees in the various oil payment conveyances here involved clearly meet these tests. Each grantee had unlimited power to dispose of his interest by gift, sale or otherwise, without liability to anyone. A catastrophe causing the loss of the oil re-

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*Cf. *Anderson* v. *Helvering*, 310 U.S. 404, where the holder of an interest somewhat similar to an oil payment interest had a right to look to sources other than oil and gas when, as and if produced, for the recovery of his investment.

serve or rendering it incapable of being produced would fall solely upon the grantee in such an oil payment conveyance to the extent of his interest, if the catastrophe occurred without the fault of another. It could be taken for his debt, but not for the debt of another.

The yield from each oil payment conveyance was, as this yield was received or accrued, the income of the oil payment holder. Here again is another compelling proof that the grantees in these oil payment conveyances were the owners of interests in the property, for the income from property is taxable to the owner of the property. *Poe* v. *Seaborn*, 282 U.S. 101; *Home Savings Bank* v. *Des Moines*, 205 U.S. 503. See also *Knowlton* v. *Moore*, 178 U.S. 41; *Hoepner* v. *Tax Commission of Wisconsin*, 284 U.S. 206 and *Nichols* v. *Coolidge*, 274 U.S. 531.

It is further established by the decisions of this Court that one whose rights to oil or gas attach after production as, for example, one who has a contractual right to take and process gas after it has been produced does not have an economic interest (ownership) in the gas reserve, and is, therefore, not entitled to depletion. *Helvering* v. *Bankline Oil Company*, 303 U.S. 362.*

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*This case involved the right to depletion of one who had by various contractual arrangements acquired rights to casinghead gas after it had been produced. Because Bankline Oil Company's rights did not attach until after production and it did not have an economic interest in the gas reserve or any part in the producing operation, the right to depletion was denied. Conversely when, as here, depletion must be

That an oil and gas leasehold estate can be divided into an oil payment interest and a working interest, consisting of the entire leasehold estate less the oil payment interest, and with all costs of development and operation attaching exclusively to such working interest, is clearly established by *Thomas* v. *Perkins*, 301 U.S. 655. There, although Perkins' assignors did not expressly reserve in their assignment any interest in the leaseholds, the assignment did provide for the payment to those assignors—

> "* * * of the further sum of Three Hundred Ninety Five Thousand Dollars ($395,000) to be paid out of the oil produced and saved from the hereinafter described lands, and to be one-fourth of all of the oil produced and saved from the premises hereinafter described until the full sum of Three Hundred Ninety Five Thousand Dollars ($395,000) is paid. * * * As hereinbefore stated, Three Hundred Ninety Five Thousand Dollars ($395,000) is to be paid to Mamie S. Hammonds and Fred P. Branson, each to receive one-half thereof out of oil produced and saved from said leased premises, which payment shall be paid by the Pipe Line Company or other purchaser of said oil, and shall be one-fourth of all of the oil produced and saved from the above described land until the full sum of Three Hundred Ninety Five Thousand Dollars ($395,000) is fully paid. * * *

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allowed to the oil payment holder on his income, it is necessarily established—contrary to petitioners' argument—that the oil payment holder's rights attached before production, were not assignments of oil after production or of the right to collect for the assignor's oil.

> *It is understood and agreed that said Three Hundred Ninety Five Thousand Dollars ($395,000) is payable out of oil only if, as and when produced from the land above described, and said payment shall not constitute and shall not be a personal obligation of the assignee* * * * (Emphasis supplied)

Under these facts, and despite the informality of the oil payment reservation, this Court concluded:

> "As Hammonds and Branson, the assignors in this case, would be entitled to an allowance for depletion in respect of the oil sold out of their share, the income from that interest is not chargeable to respondents, Perkins and wife. It follows that the Commissioner erred in including in their income the payments made by purchasers to assignors for their share of the oil."

Earlier in this opinion, in discussing *Palmer* v. *Bender*, *supra*, the Court said:

> "If Palmer had retained no interest in the oil, he would have been entitled to no deduction on account of depletion. Ownership was essential."

These established principles force petitioners to the position that although a depletable economic interest (ownership) in the nature of an oil payment interest can be retained in an assignment of an oil and gas leasehold, a similar interest cannot be carved out and conveyed with the retention of the remainder of the working interest and the burdens of operating and

developing; that such a carving out and conveyance is not an assignment of a depletable economic interest, but is of future income. But clearly there are no rules of conveyancing of local or general application which even hint at the proposition that a particular type of interest can be retained in a conveyance, but that the same type of interest cannot be conveyed out of the larger interest.

This Court's most recent decision dealing with oil properties and depletion fully supports what has been said above. In *Commissioner* v. *Southwest Exploration Company*, 350 U.S. 308, this Court dealt with a unique situation giving rise to conflicting claims for a depletion allowance. The Exploration Company, in order to acquire from the State of California and develop for oil production certain off shore areas, was required to obtain from riparian owners the right to conduct drilling operations by directional drilling based upon these riparian lands. To obtain such rights from the riparian owners, the Exploration Company agreed to yield to the riparian owners a share of the net profits from production. Both the riparian owners and the Exploration Company asserted the right to depletion with respect to so much of the income from the operation as went to the riparian owners as net profits. This Court upheld the right of the riparian owners to the depletion allowance and denied it to the Exploration Company, holding that, by the contract granting the Exploration Company the rights described, such owners had made

an investment and acquired a depletable economic interest in the oil reserves sufficient to support their claim for depletion. Except for the contract, the riparian owners were strangers to the title to the oil reserves. They must have acquired their interest from the Exploration Company, since they had no dealings at all with California. Therefore, the depletable economic interest which the upland owners acquired in this case must have come from the Exploration Company's leasehold rights. This was a carving out strikingly similar to the oil payment conveyances now under consideration. Under the principles governing the allowance for depletion announced and continuously followed by this Court since *Palmer* v. *Bender*, *supra*, the holding in the Southwest Exploration case that the upland owners were entitled to the depletion allowance is necessarily, as this Court expressly stated, a holding that these upland owners had an economic interest (ownership) in the oil and gas reserve.[10]

That the oil payment conveyances now under consideration conveyed present interests in the properties, as distinguished from future income, is of course the holding of all the Appellate Courts which have passed upon the question except the Seventh Circuit

[10]Under *Helvering* v. *Bankline Oil Company*, 303 U.S. 362—See footnote 9, p. 23 supra, the requisite economic interest (ownership) must have attached in favor of the riparian owners to the oil reserve *in situ* and not after production, otherwise these owners would not have been entitled to a depletion allowance.

in *Commissioner* v. *Slagter*, 238 F. 2d 901,[11] the correctness of which petitioners expressly disavow, of the Tax Court in every case in which that Court has considered the question,[12] and accords with State law. Perhaps the most pertinent State Court decision is *Tennant* v. *Dunn*, 130 Tex. 285, 110 S.W. 2d 53, analyzed and extensively quoted from in the opinions below. That case involved a carved out oil payment and the highest Court of Texas expressly held that:

> "*It is not a promise to pay money. It is not a contract for the sale and delivery of oil, as personalty after production*, but it undertakes to invest the assignee, and we think it does invest her, presently with a right or interest in what the assignor owned. * * * A part of the lessee's right or interest is assigned, not a fractional interest in the entire leasehold estate but the absolute right, without charges for production or operation, to a fractional part of the oil as and when it is produced from a well on the leased land.

[11] In addition to the five opinions below see particularly *Ortiz Oil Company* v. *Commissioner*, 102 F. 2d 508, cert. denied 308 U.S. 506, Appendix C, p. 138 infra; *Commissioner* v. *I. A. O'Shaughnessy, Inc.*, 124 F. 2d 33, Appendix C, p. 143 infra; *Commissioner* v. *Rowan Drilling Company*, 130 F. 2d 62, Appendix C, p. 145 infra. *Commissioner* v. *Hawn*, 231 F. 340, does not, as is clearly demonstrated by Judge Hutcheson's opinion in the O'Connor case (R. 81 et seq), conflict with any of the cases just cited.

[12] All of the cases now under review except the O'Connor case came from the Tax Court and were decided on the capital gain question in favor of the taxpayers. The same conclusion was reached by the Board of Tax Appeals in the *Ortiz Oil Company case*, 37 B.T.A. 656, and numerous other cases.

> * * * Mrs. Dunn did not become by virtue of the assignment a mining partner or a joint adventurer, *for it gave her, not merely a part of the profits of the enterprise, but an interest in land free of charges for development or operation and without obligation to share in losses.* * * * (Emphasis supplied)

The contention of the petitioners (Petitioners' brief, pp. 38-40) that the grantees of the oil payment interests involved did not make a capital investment in the oil in place and that no such investment is made unless it represents an "indispensable contribution" to oil production is wholly unsound. In the first place, the phrase "indispensable contribution" is lifted out of context from this Court's opinion in the *Southwest Exploration* case. In using it, the Court was answering the Exploration Company's argument that a depletable economic interest is not acquired by one whose investment does not represent an "indispensable contribution" to the producing operation, and this Court merely held that by granting the right to use the riparian lands their owners had made an investment and that it was under the circumstances indispensable to the Exploration Company, in that such rights had to be acquired in order to develop the property. This cannot be tortured into a holding that the consideration (the investment) paid by a purchaser for a depletable economic interest must go into the property itself in order for that purchaser to acquire the requisite depletable economic interest. Under such a doctrine any one who acquired an entire oil and gas leasehold for cash,

which the seller used for such purposes as he saw fit, and not upon the property in which he had no further interest, would not acquire a depletable economic interest. Such a doctrine is not and has never been the law as the cited cases show.

Whatever plausibility there may be in petitioners' argument that the assignments in question were of future income and not present interests in the property, were fruit not tree, is based upon a misconception of the unique character, tax wise, of oil and other mineral holdings. Certainly petitioners will not argue that an oil reserve is not property or is not capital. They will not argue that no sale of an oil reserve can produce capital gain.[13] Yet the oil reserve, because it is incapable of replacement, and has no economic value (other than for resale) except to the extent that the oil reserve is produced and made commercially available and thereby exhausted, produces a yield which when the producing operation is completed is entirely income, taxable as such, without any deductions for depletion or loss of capital other than those Congressional grace expressly permits. Thus an oil reserve is not like a tree which yields fruit from year to year leaving the tree intact and capable of producing another crop. When the oil is produced the entire property, which was previously entirely capital, becomes entirely income, leaving nothing of

[13]**The petitioners' own rulings are to the contrary. See *I.T. 3693*, Appendix B, p. 112 infra; *G.C.M. 12118*, Appendix B, p. 84 infra; *G.C.M. 22730*, Appendix B, p. 88 infra.**

the original capital investment, no matter how large it might have been, except what Congress expressly permits to be deducted from the income. This unique situation arises regardless of the precise character of ownership in the oil reserve. It is true of a fee owner who develops and produces oil from his own lands. It is true as to the landowner's royalty interest. It is true as to ordinary leasehold working interests. It is true of overriding royalties, of oil payment interests and of net profit interests. The very principle upon which petitioners rely to establish that the conveyances here under consideration were of future income is equally applicable to an assignment of any of the interests just enumerated, or any part thereof. But this argument proves too much. It is directly contrary to what everyone admits, which is that the conveyance of any of the interests enumerated or continuing undivided interests in them, save and except only the carving out and sale of an oil payment interest, are not assignments of future income but are conveyances of property which, when the other statutory requirements are met, produce long term capital gain.

Therefore we say that the oil payment conveyances here involved conveyed depletable economic interests (ownership) in the property interests from which they were carved and were not merely assignments of future income. With this established we shall proceed, first, to a consideration of the non-taxable exchange question involved only in the Fleming case, and then to a consideration of the capital gain issue which must

be decided in the Lake case, and which will be reached in the Fleming case only if this Court reverses the Court below in holding that the gain from the Fleming exchanges was not to be recognized under *Section 112 (b)(1)* Internal Revenue Code of 1939.

II.

The oil-payment interests conveyed by the Flemings and Walsh, and the lands which they received, were properties of like kind within the purview of Section 112(b)(1), Internal Revenue Code of 1939, so that no gain is to be recognized from the exchange.

The governing statute, which in substantially the same form has been in revenue legislation since 1921,[14] provides that if certain conditions are met, no gain or loss from the exchange of properties of like kind is to be recognized. The statutory provision excludes from its scope practically all intangible property, "stock in trade, or other property held primarily for sale, * * *, stocks, bonds, notes, choses in action, certificates of trust or beneficial interests or other securities or other evidences of indebtedness or interest." Except for this limitation, if "property held for productive use in trade or business or for investment," is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment, "no gain or loss shall be recognized." (Section 112(b)(1), I.R.C. of 1939, p. 73,

[14]The original non-taxable exchange provision first appeared as *Section 202(c)* of the Revenue Act of 1921.

infra.) It was stipulated that the taxpayers in the *Fleming* case held the oil properties involved, for productive use in their trade or business and not for sale (R. 162, 166), and that the ranch and urban lands received by the taxpayers in their exchanges were acquired and held for investment (R. 162, 166). Therefore, if what the taxpayers exchanged was a part of their oil holdings and was like in kind to the lands which they received, the requirements of the statute are met and the statutory mandate that no gain or loss be recognized from the exchange is clear.

It has been established under Subdivision I of this argument, pages 18 to 32, supra, that the oil payment interests conveyed by the Flemings were interests in land—real property. See also *Fleming* v. *Campbell*, 205 F. 2d 549, summarized in Appendix C, page 147 infra, as well as other cases summarized in that Appendix.

From the Regulations promulgated under the Revenue Act of 1921—when the prototype of Section 112 (b) (1), Internal Revenue Code of 1939 was adopted[18]

[18]Regulations 62, relating to the Revenue Act of 1921, provides in Article 1566: "Where property held for investment is exchanged for other property of a like kind, or where property held for productive use in trade or business is exchanged for other property of a like use * * * (no gain or loss is recognized). The words 'like kind' are defined as having reference to the nature or character of the property and not its grade or quality * * *. The fact that any real estate involved in an exchange is improved or unimproved makes no difference for such fact relates to only the grade or quality of property and not to its kind or class."

—to the present time, the Regulations have provided that the words "like kind" used in the statute have reference to the nature or character of the property and not to its grade or quality. As illustrative of this, the Regulations have provided, "The fact that any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class." A further illustration in the Regulations is that "no gain or loss is recognized if * * * (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with thirty years or more to run, for real estate, or improved real estate for unimproved real estate."

The only pertinent appellate court decisions are those of the court below. Each involved the identical or substantially the same statutory provision and the identical or substantially the same Treasury Regulation. In 1941, in *Commissioner* v. *Crichton*, 122 F. 2d 181, the court below, after expressly approving the Treasury Regulation then in force, held that mineral interests under Louisiana rural lands could be exchanged for an interest in urban property without recognition of gain.[16] In 1953, in *Fleming* v. *Campbell*, 205 F. 2d 549, the court below held that a carved-out oil payment was property like in kind to a landowner's perpetual mineral interest, so that an exchange of the two types of property came within the

[16]The *Crichton case* is more fully summarized in Appendix C, p. 142 infra. These regulations were also expressly approved in *Century Electric Co.* v. *Com.* 192 F. 2d. 155, cert. den. 342 U.S. 954.

statutory non-recognition provision under consideration. In this case, the court also held that the provision in the Regulation with respect to "a leasehold of a fee with thirty years or more to run" plainly referred to the ordinary leasehold and had no application to an oil, gas or mining lease.[17]

It should be noted that *Fleming* v. *Campbell, supra,* was decided before the Internal Revenue Code of 1954 was enacted, and that Congress reenacted the statute in substantially identical terms, and again the provisions of the earlier Treasury Regulations were re-adopted without material change.

Further supporting the non-taxable-exchange theory are two rulings of the Internal Revenue Service. The first, I.T. 4093, C.B. 1952-2, page 130, held that a producing oil lease which could extend until the exhaustion of the deposit could be exchanged for ranch lands without the recognition of gain or loss to either party.[18] This opinion not only cites the *Crichton* case but states that, "It is the position of the Bureau that the interest of a lessee in a producing oil lease extending until the exhaustion of the deposit constitutes an interest in real property for federal tax purposes (see I.T. 3693, C.B. 1944, p. 272; and *Palmer* v. *Bender*, 287 U.S. 551* * *)."

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[17] *Fleming* v. *Campbell, supra,* is more fully summarized and quoted from in Appendix C, p. 147 infra.

[18] *I.T. 4093* is reproduced in full in Appendix B, p. 127 et seq. infra.

In Internal Revenue Ruling 55-749, 1955 C.B. 2, p. 295, it was held that a perpetual water right (a right to obtain water for irrigation purposes) was property like in kind to a fee simple interest in land, and could be exchanged without recognition of gain under Section 1031 (a), Internal Revenue Code of 1954, which is the reenactment of the Section 112(b)(1), Internal Revenue Code of 1939 here under consideration.[19]

In opposition to the views above expressed, the Commissioner argues, first, that the conveyances were assignments of future income, which is the same argument advanced in opposition to the capital-gain question in all of the five cases grouped in petitioners' petition for certiorari and now being considered. This proposition has been dealt with separately under subdivision I of this argument, pages 18-32, *supra*, but some other points advanced will be considered. At page 56 of the petitioners' brief it is stated that "Actually * * * the Flemings' oil-payment assignments were merely arrangements for delayed cash payment of the purchase price of real estate plus interest thereon." As applied to the facts and the deficiency determination under review, this is a statement that by arranging for the "delayed cash payment of the purchase price of real estate" the taxpayer received ordinary depletable income. This, we believe, is the first time the

[19] *I.R.R. 55-749* is reproduced in full in Appendix B, p. 131 et seq. infra.

Treasury has ever advanced the argument that arranging to purchase real estate for delayed cash payments produced ordinary depletable income from property—or, in fact, the first time it has ever been seriously contended that any purchase produced taxable income. It would seem that although petitioners disavow the holding in *Commissioner* v. *Slagter*, 238 F. 2d 901, to the effect that the consideration received for the conveyance of a carved-out oil payment is to be treated as a loan, they are here adopting that view. Of course if that view were correct, then the Fleming taxpayers received no income when the exchanges were made, whether or not they come within Section 112(b)(1), but received income largely in future years as the oil applicable to the oil payments was produced and applied to what the petitioners term "purchase price of real estate plus interest thereon."

The *Crichton* case, *supra*, based its holding to some extent upon the nature of the properties exchanged as determined by State law, as well as upon an interpretation and approval of Treasury Regulations. I. T. 4093, *supra*, cited and approved the Crichton case in 1952. In 1955, in I.R.R. 55-749, supra, "applicable State law" was again made the criterion for determining likeness in kind. Similarity in appearance, in use or other attributes is clearly not the test of likeness in kind as used in the governing statute. This is completely demonstrated by the cited rulings as to

the likeness in kind of water rights and fee interests in land and of oil and gas leaseholds and ranch lands.

The statutory provision is not to be construed as an exemption statute. Under the related "basis" section of the law,[20] the basis of the property exchanged becomes the basis of the property received in exchange, so that in accordance with a congressional purpose which has not been departed from since 1921, and which was reaffirmed when the Internal Revenue Code of 1954 was adopted, the taxation of income is merely deferred until realized from the asset received in exchange.

The types of property which are excepted from the application of Section 112(b)(1) are "stock in trade or other property held primarily for sale * * * stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest". With these exceptions any property "held for productive use in trade or business or for investment" can be exchanged for other property to be held for productive use in trade or business or for investment, provided only that the exchanged properties are "of like kind", that is, of the same nature or character. Clearly the oil payment interests which the Flemings exchanged do not come within any of the excepting provisions just quoted. Such oil payments are not stock in trade, were not held primarily for sale, are not stocks, bonds or any

[20] Section 113(a)(6) I.R.C. of 1939.

other specified items of property. It follows that such oil payments, since they are not mere assignments of future income (as has been demonstrated elsewhere herein), can be exchanged without the recognition of gain for some other type of property, if the property received is held for productive use in trade or business or for investment. Breeding cattle, trucks or buses, trade fixtures, factory machinery not affixed so as to become part of real estate are all types of property which can be acquired and held for productive use in trade or business. Are they more like in kind to oil payment interests than real estate? Would it more nearly accord with the petitioners' view as to how the statute is to be applied if the Flemings had received properties of any of the types just mentioned solely in consideration for their oil payments? It would seem that the petitioners must choose one or the other horn of this dilemma, or must take the wholly insupportable position that an oil payment is neither "fish nor fowl" and cannot be exchanged either for real estate or for chattels under Section 112(b)(1) of the 1939 Code. This is a wholly indefensible position.

It is therefore submitted that the Fleming case should be disposed of by holding that Section 112(b)(1) of the 1939 Code applies, and that the Fleming taxpayers received no recognizable gain from their exchanges.

III.

For many years prior to the determination of the deficiencies involved in both the Fleming and Lake cases, the Treasury's administrative practice was to treat the sale of a carved-out oil payment as productive of long-term capital gain if the other statutory requirements of such treatment were present. This position had received judicial and congressional approval and had become so crystallized into the law that a change should not be permitted—particularly when the change is applied retroactively.

Since the first statutory provision dealing with capital-gain taxation was enacted in 1921, down through and including the Internal Revenue Code of 1954, there has been no change in the "capital-gain" sections of the various Revenue Acts and Codes directly pertinent to this proceeding. If the sale of a carved-out oil payment would have produced long-term capital gain under the Revenue Act of 1921, there is no statutory reason why such a transaction would not produce long-term capital gain under the Internal Revenue Code of 1939 or that of 1954, or under any of the numerous Revenue Acts enacted between 1921 and the 1939 Code.

Until 1946, the practice of the Commissioner was to treat the sale of a carved-out oil payment (if statutory requirements as to holding period, etc., had been met) as productive of long-term capital gain. In

1946, G.C.M. 24849 was published, in C.B. 1946-1, at page 66. That opinion (reproduced in full in Appendix B hereto, page 117, *infra*) is limited in its application to what is there termed "short-lived in-oil-payment rights," which the opinion states "ordinarily pay out and expire within one or two years," and the ruling, while expressing no opinion as to the status of oil-payment rights extending over a substantial portion of the life of the depletable economic interests from which such rights are carved, went on to hold that the assignment and sale of a short-lived oil payment produced ordinary depletable income. That this was a complete reversal of the previous position and practice of the Commissioner is conclusively shown by I.T. 3895, C.B. 1948-1, page 39, ruling that G.C.M. 24849 would not be given retroactive application but would be applied "only to such assignments made on or after April 1, 1946." It was not until 1950 that the Commissioner entirely departed from his earlier practices by ruling, in I.T. 4003, C.B. 1950-1, page 10, in substance that there was no legal or economic basis for distinguishing between long-lived and short-lived oil payments, and that the carving out and sale of an oil-payment interest which extended over a period of less than the life of the depletable property interest from which it was carved produced ordinary depletable income.[21]

[21]Both *I.T. 3895* and *I.T. 4003* are reproduced in full in Appendix B, hereto, p. 124 and p. 125, et seq., infra.

Prior to the promulgation of G.C.M. 24849, it had been expressly held, at the instance of the Commissioner, that the carving out and sale of an oil payment which paid out in approximately four years was a sale of an interest in the leaseholds, so that the seller was not entitled to an allowance of depletion against the consideration received but could merely deduct therefrom an aliquot portion of cost as in the case of the sale of any other type of property; that the transaction constituted "a sale of oil in place"; and that the purchaser of the oil payment "simply acquired an interest in oil in place. The right to share in the oil produced constituted an economic interest in the properties to the amount agreed upon. *Palmer* v. *Bender*, 287 U.S. 551." In the same case it was held that a purchaser of the carved-out-oil-payment interest was entitled to depletion as oil applicable to the oil payment was produced. *Ortiz Oil Company* v. *Commissioner*, 102 F. 2d 508 (C.A., March 14, 1939), affirming 37 B.T.A. 656, cert. den. 308 U.S. 566.[22] Likewise prior to the promulgation of G.C.M. 24849, there had been a rather full development by judicial decision of the nature of oil-payment interests, the right of the owner of such an interest to depletion, and related tax problems. Many of these cases are

[22]See Appendix C, p. 138 infra for a fuller treatment of the Ortiz case. Capital gain was not allowed Ortiz Oil Company in that case because under the applicable statute no corporation was allowed capital gain benefits. Section 101 Revenue Act of 1932. Even if the taxpayer had not been a corporation, the facts show that the oil leases had not been held for the requisite period of time for capital gain treatment.

collated elsewhere in this brief and will not be further discussed here, but all are directly opposed to some or all of the views expressed in G.C.M. 24849 or the later I.T. 4003.[23]

We submit that the administrative practices existing prior to 1946, judicially approved—and at least inferentially approved by Congress through repeated reenactments of the pertinent statutory provision—had become crystallized as a part of the law, placing it beyond the power of the Commissioner, without congressional sanction, to change the rule, prospectively or retroactively. Sufficient authority for this is found in this Court's recent holding in *United States* v. *Leslie Salt Company*, 350 U.S. 383, decided March 5, 1956. That case involved an attempt on the part of the Commissioner—emboldened by his victory in *General Motors Acceptance Corporation* v. *Higgins*, 161 F. 2d 593—to extend, by ruling, the section of the tax law levying a stamp tax upon bonds, debentures, certificates of indebtedness and other corporate securities, to promissory notes issued by Leslie Salt Company and privately placed with two insurance companies. It was argued in much the same vein as the argument advanced in the petition for certiorari to the effect that the Treasury was suffering from the

[23]See the summary of cases in Appendix C, pages 135 to 152, infra, and the discussion under the first subdivision of this argument, pages 18 to 32 supra.

sale of carved-out oil payments,[*] that, if the currently employed method of privately placing large corporate notes with investors had been brought to the attention of Congress when the law was under consideration, transactions like that of Leslie Salt Company would have been included in the statutory scope.

In denying the Commissioner his assumed legislative prerogative, this Court quoted from *Norwegian Nitrogen Products Company* v. *United States*, 288 U.S. 294, 315, as follows:

> "* * * adminstrative practice, consistent and generally unchallenged, will not be overturned except for very cogent reasons if the scope of the command is indefinite and doubtful. United States v. Moore, 95 U.S. 760, 763; 24 L.Ed. 588; Logan v. Davis, 233 U.S. 613, 627, 34 S.Ct. 685, 58 L.Ed. 1121; Brewster v. Gage, 280 U.S. 327, 336, 50 S.Ct. 115, 74 L.Ed. 457; Fawcus Machine Co. v. United States, 282 U.S. 375, 51 S.Ct. 144, 75 L.Ed. 397; Interstate Commerce Comm. v. New York, N.H. & H.R. Co., 287 U.S. 178, 53

[*] "We believe this argument is factually unsound as well as legally immaterial. The petitioners' theory is a two-edged sword. If correct, it would permit oil operators through the device of selling oil payments—short-lived or long-lived—to concentrate ordinary depletable income from the property in the year most advantageous to them, and by avoiding the impact of the limitation on percentage depletion to not more than 50% of the net income from the property, calculated without an allowance for depletion, materially increase their statutory percentage depletion allowances which, as petitioners' point out in their brief, are not limited to cost or other basis in the property.

> S.Ct. 106, 77 L.Ed. 248 * * *. The practice has peculiar weight when it involves a contemporaneous construction of a statute by the men charged with the responsibility of setting its machinery in motion, of making the parts work efficiently and smoothly while they are yet untried and new."

and then said:

> "Against the Treasury's prior longstanding and consistent administrative interpretation its more recent *ad hoc* contention as to how the statute should be construed cannot stand. Moreover, that original interpretation has had both express and implied congressional acquiescence, through the 1918 amendment to the statute (76 S.Ct. 421), which has ever since continued in effect, and through Congress having let the administrative interpretation remain undisturbed for so many years. See Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 53, 76 S.Ct. 20, 24; Norwegian Nitrogen Products Co. v. United States, supra, 288 U.S. at page 313, 53 S.Ct. at page 357."

It should be noted that the *General Motors Acceptance Corporation* case was decided in 1947, while the Leslie Salt Company transaction occurred in 1949, but this fact was not allowed to strengthen the Commissioner's power to change his position.

If the power to change position prospectively when the change is supported to some extent by a court decision is to be denied to the Commissioner, as was done

in the Leslie Salt Company case, there is much more reason to deny any retroactive effect to the change in position, particularly when it is not supported by a single court decision or any congressional action. In 1948 when the Fleming-Cline exchange was made, and in 1949 when the Walsh-Cross exchange was made, neither of which involved short-lived oil payments as the term was used in G.C.M. 24849, there was not a single ruling, judicial decision, or congressional action or inaction, which indicated to any taxpayer that there would be a change in the treatment of proceeds received for the sale of long-lived oil payments.[25] So, as far as the *Fleming* case is concerned, in addition to the plain pronouncement in the *Leslie Salt Company* case denying the right to change prospectively the rules applicable to the *Lake* case, we have the added vice of retroactivity.

Therefore, we earnestly urge that the *Leslie Salt Company* case is sufficient and compelling authority for the affirmance of the holdings below on the capital-gain issue, and that the Commissioner should be told that if he was dissatisfied with his earlier long-continued practice he should have sought legislative relief.

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[25] As petitioners point out in their brief (pp. 11-12) the Fleming oil payments had lives varying from five years and eight months to "ten to twelve years". The Walsh oil payment had an estimated life of three and one-half years.

IV.

Taxpayers' oil-payment conveyances were sales (or exchanges) of fractional interests in the taxpayers' leasehold (or mineral) interests, conveying for a consideration depletable economic interests (ownership) and fully meeting the statutory requirements for capital-gain treatment.

This Court and other Courts have held that contractual provisions which under ordinary tests would not be classified as formal reservations or conveyances were sufficient to retain or to convey depletable economic interests (ownership) in oil reserves. *Thomas* v. *Perkins*, 301 U.S. 655; *Commissioner* v. *Southwest Exploration Company*, 350 U.S. 308, and several of the cases summarized in Appendix C hereto, infra pp. 135 to 152, clearly establish this. In the cases now under consideration we have no lack of formality. Each instrument in the familiar language of conveyances purported to bargain, sell, assign and convey interests in the oil and gas leases (R. 9, 168, 171, 173, 175, 178). Clearly, to the extent it is legally possible so to do, these conveyances accomplished sales of present interests in the taxpayers' respective properties. That it is possible to convey such present interests is fully established by the decisions of this Court, of the highest Court of Texas, by many Circuit Court and Tax Court decisions, and, indeed, by the Treasury's own rulings, all of which have been heretofore cited and discussed.

That the transactions meet all of the literal requirements for long-term capital-gain treatment laid down in *Section 117 I.R.C.* of 1939 is equally clear. It was stipulated that the taxpayers had held their respective properties for productive use in their trades and businesses of producing oil, and not for sale, for the time required by the statute, and, indeed, for much longer than the required time; that these holdings were property and that the interests conveyed were parts thereof is equally clear. That whether the taxpayers' holdings and the interests conveyed be considered "real property used in * * * trade or business" is immaterial in determining the applicability of the capital gain provisions in these cases has been heretofore demonstrated. (Footnote 5, p. 19 supra). By stipulation and undisputed facts these interests are not inventoriable property, stock in trade or property held primarily for sale to customers, and, of course, the statutory exceptions as to copyrights, etc., and governmental obligations issued at a discount have no possible application. These exhaust the statutory exception to the general definition of "capital assets", which by the statute means "property held by the taxpayer (whether or not connected with his trade or business)" with the exclusions just specified.

These transactions come as clearly within the spirit and purpose of Section 117, I.R.C. of 1939 as they come within its letter. The capital gain provisions of the 1939 Code, as well as those of the Internal Revenue Code of 1954, are a continuation of those first enacted

in the Revenue Act of 1921 and there made applicable only to non-corporate taxpayers. The 1921 provisions did not, as more recent statutory provisions do, limit the deduction for capital losses except to the extent that they offset capital gains. The original holding period required was two years. It is clear that the 1921 provisions were enacted for a double purpose, first, to avoid the injustice which would result if taxpayers were taxed at ordinary income tax rates on the gain realized from holdings where the gain represented an enhancement in value occurring over a period of years; and, second, to encourage such realizations and thereby produce revenue which would not be available if high surtax rates discouraged the realization of such enhancements. At an early date this Court said, with respect to these provisions:

> "The exemption of income devoted to charity and the reduction of the rate of tax on capital gains were liberalizations of the law in the taxpayer's favor, were begotten from motives of public policy, and are not to be narrowly construed." *Helvering* v. *Bliss*, 293 U.S. 144, 151.

Between the adoption of the Revenue Act of 1921 and the present time, Congress made many changes in the statutory provisions relative to the taxation of capital gains. Among those pertinent here are the following: There were changes in the requisite holding period. At one time the early and present flat rate of taxation was done away with and different percentages of gain, depending upon holding period, were includible as ordinary income. Thus under one Act

capital gain on property held for less than one year was included in ordinary income in its entirety, while, if the property had been held for ten years or more, only thirty per cent was included. Later the flat rate was reinstated and has been applicable at least since the adoption of the Internal Revenue Code of 1939. With the increase in the rate of taxation on corporate income, capital gains realized by corporations were taxed substantially as were capital gains realized by non-corporate taxpayers. Distinctions between long-term and short-term capital-gain were introduced and provisions sharply limiting the deductibility of both short-term and long-term capital losses were adopted. As questions arose as to whether certain transaction did or did not produce capital gain, Congress by express statutory provision made it clear that it was intended that capital gain treatment be applied in these disputed areas. Examples may be found in the treatment accorded gain from the sale of growing crops, timber, livestock held for breeding purposes, etc.[26] Most important, Congress reduced the requisite holding period for both long-term capital gains and losses to six months.[27]

When Congress adopted a six month holding period as the standard for determining whether long-term capital gain or loss treatment was to be applied, it clearly departed from one of the purposes which im-

[26]Sec. 117(j)(1), (3)(k) I.R.C. of 1939.

1958 Standard Federal Tax Service (C.C.H.) Vol. 4, pp. 47,005-6.

[27]Sec. 117(a)(4) and (5) I.R.C. of 1939.

pelled the adoption of the capital gain provisions first contained in the Revenue Act of 1921. When, for example, the gain from the sale of corporate stock owned for six months and one day is taxed at exactly the same rate as a similar amount of gain realized from the sale of stock held for ten or twenty years, it is impossible to say that the statutory provision was enacted to prevent the injustice of taxing, at progressive rates, realized enhancement in value occuring over a long period of years. This, taken in connection with the provisions limiting the deductibility of capital losses, forces the conclusion that at least since 1939 the Congressional purpose was to protect the revenue by limiting the deduction of losses from the sales of capital assets, and to increase the revenue by encouraging sales and realization of capital gain, which sales would be most effectively discouraged if resulting gains were taxed at progressive rates.

The express terms of *Section 117*, I.R.C. of 1939 show the Congressional purpose, and, when these are applied with reasonable regard for the ordinary meaning of the terms used, this Congressional purpose will be accomplished. Congress could scarcely have used a broader term than the word "property". That it was to be broadly applied is emphasized by the parenthetical clause immediately following—"whether or not connected with his trade or business." Realization of gain "by sale or exchange" is required. This excludes income from services, rents, interests, dividends, etc. Income from trading, merchandising,

manufacturing and related activities is excluded by the excepting provisions "stock in trade, inventoriable property, property held primarily for sale to customers", as is income from sales of certain types of property—copyrights, certain governmental obligations, etc., heretofore discussed.

Considered together all of these factors force the conclusion that Congress intended to include within the capital gain and loss provisions of the 1939 Code all sales or exchanges of property, except those specifically excepted, and those which arose and recurred in the ordinary day to day business of a taxpayer. So we submit that these taxpayers' conveyances give rise to long-term capital gain because they come within the spirit as well as the letter of Section 117 of the Internal Revenue Code of 1939.

To meet this petitioners rely primarily upon *Watson* v. *Commissioner*, 345 U.S. 544, and *Corn Products Company* v. *Commissioner*, 350 U.S. 46. The Watson case dealt with the sale of an interest in an orchard and the rapidly maturing crop on the trees, which crop was the principal element in value. The holding of this Court in the *Watson* case was that the fact that, by State law, the growing crop was classified as real estate did not prevent it from being property held primarily for sale to customers within the except-

ing provision of the capital gain section.[28] This situation might be compared to the sale by a merchant of the building occupied by his store, to trade fixtures and his stock of merchandise. Any gain realized from the sale of the merchandise would of course be gain from property held primarily for sale to customers and, no doubt, would be inventoriable property. The fact that the other interests sold (real estate and fixtures) might qualify for capital gain treatment would not prevent the express statutory provision as to property held primarily for sale to customers from being applied. Likewise, Mrs. Watson was holding her fruit crop—but not the trees—for sale to customers in the ordinary course of her business. There is nothing in the statute which makes any item of property any less property held for sale to customers because it is actually real estate or is classified by State law as real estate. Real estate can be held for sale to customers as is evidenced by the almost innumerable decisions dealing with the subdivision and sale of real estate.

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[28] In the *Watson* case this Court was careful to say, 345 U.S. 544-552: "We do not have here the situation which arises from the sale of land, including coal or other mineral wealth not separated from its natural state and not in the course of annual growth leading to a seasonal separation. See Butler Consolidated Coal Co. v. Commissioner, 6 T.C. 183. The instant case also is distinguishable from that of growing timber which is not in itself an annual or short-term product. See Carroll v. Commissioner, 70 F. 2d 806; Camp Manufacturing Co. v. Commissioner, 3 T.C. 467."

Nor does the holding of this Court in the *Corn Products Company* case *supra*, justify the denial of capital-gain treatment to these taxpayers. As this Court's opinion in that case emphasizes, the transactions in corn futures there under consideration were recurring, day to day, transactions designed to reduce or stabilize the cost to Corn Products of the raw materials used in its manufacturing business, entered into for that express purpose and effectively accomplishing that result. If we assume—and we think such assumption is directly contrary to the facts—that by this Court's statement in the *Corn Products Company* case that the capital gain provisions are to be narrowly applied so as to effectuate the Congressional policy of taxing at ordinary income rates the profits "arising from the every day operation of a business" this Court overruled its statement in *Helvering* v. *Bliss*, *supra*, that the capital-gain section was not to be "narrowly construed", it avails petitioners nothing. For this Court went on to say that the capital-gain section should not be applied to profits "arising from the every day operation of a business" and capital-gain treatment should be limited "to transactions in property which are not the normal source of business income." The taxpayers' transactions now under consideration by the Court were not, as the stipulation and admitted facts clearly show, every day operations and were not the "normal source of business income" of these taxpayers. They were isolated sales by which these taxpayers realized enhancement in value of a portion of their property interests by

separate, single and isolated transactions, and are therefore within the spirit and the letter of Section 117 of the Internal Revenue Code of 1939.

V.

Petitioners' actions and theories necessarily result in excessive depletion allowances forbidden both by the statute and the express holdings of this Court.

It has been established that those to whom the taxpayers conveyed the oil payment interests in their respective properties thereby acquired depletable economic interests in such properties. Such grantees made investments which entitled them to a share of the oil to be produced from the respective properties when, as, and if, but only when, as, and if, such oil was produced, and gave them no right to look to any source other than oil when, as, and if produced, for the recovery of their investment. That such an interest in an oil property is a depletable economic interest is conclusively established by the decisions of this Court and other Courts which have been heretofore cited and discussed.[29]

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[29]See argument pp. 20 to 22 supra, and cases there cited. That the grantees in the several oil payment conveyances acquired depletable economic interests is conclusively established by *Palmer* v. *Bender*, 287 U.S. 551; *Thomas* v. *Perkins*, 301 U.S. 655, and other cases by this Court down to and including, *Commissioner* v. *Southwest Exploration Company*, 350 U.S. 308.

But the Commissioner, in determining the deficiencies against the several taxpayers here under consideration, allowed to each taxpayer depletion with respect to the consideration received for the oil payment interest conveyed. This is an essential part of the petitioners' theory of the case, which in essence is that the conveyances were not conveyances of present interest in property—capital assets—but assignments of future income from the future production of the property.

The holdings of this Court further show that depletion is allowable to a taxpayer only with respect to the oil which comes from his economic interest, and not with respect to the oil which comes from the interest of another, and, contrawise, that no taxpayer can be denied depletion on what is actually his share of the production.[39]

Thus, if the Commissioner's determinations with respect to depletion are correct, we would have this result: If a carved out oil payment was to come from one-fourth of future production, the assignor of the carved out oil payment would be allowed depletion on the consideration which he received for the oil payment upon the theory that it was a realization of the oil to be produced in the future applicable to this interest. Then, when the oil was actually produced and reported as the income of the oil payment holder, as

[39] *Helvering* v. *Twin Bell Oil Syndicate*, 293 U.S. 312. Treasury Regulations have consistently been to the same effect. See Sec. 39.23(m)-1-(b) of Treasury Regulations 118, Appendix A, infra.

it must be under the cited decisions of this Court and other Courts, the oil payment holder would be granted a depletion allowance with respect to the self-same oil. Thus depletion would be allowed with respect to more than 100% of the oil produced. This is expressly forbidden by the holding of this Court in *Helvering* v. *Twin Bell Oil Syndicate*, 293 U.S. 312, where this Court said that the depletion section "must be read in the light of the requirement of apportionment of a single depletion allowance"; that "gross income from the property" in the depletion section "points only to gross income from oil and gas"; and that the result contended for by the taxpayer in that case "would be a total allowance of 27-1/2 per cent of five-fourths of the total production" and not permissable.

The vice of the petitioners' position is most effectively and irrefutably stated by Judge Hutcheson in his opinion in the Lake case (R. 26) where he stated:

> "This brings us at last to what in our opinion is the crowning inconsistency of the commissioner's whole argument. This is that the government, through the commissioner, has the right and power to remake or reinterpret their contract for the parties, so that, though according to the teachings of all the cases, the assignee and not the assignor of a mineral interest, under instruments like those here, is entitled to take depletion on it, the commissioner can by his intervention deprive the assignee of his contract right to depletion in the years following and require the assignor to

> take it all in the year of the sale before the right to it has arisen. Of course, if the instrument transferred an economic interest in the oil, the commissioner cannot do this."

It was perhaps in an effort to meet this argument that petitioners' brief stated (Footnote 17 page 37)—

> "It should be noted that, even if the assignments did convey an economic interest in the oil in place, the assignees would be entitled to depletion only on the excess of the oil payments over the amount paid for the assignments."

This is an obviously incorrect statement. It does not accord with the present or past tax practices of the Commissioner. We assume that it was an inadvertent error and, as heretofore stated, it has been called to the attention of petitioners' counsel, and will no doubt be corrected. Whether or not this is done, it is obvious that such a treatment would itself fly into the face of the *Twin Bell Oil Syndicate* case and the express provisions of the statute. One holding an economic interest in an oil property is entitled to an allowance for depletion based either upon cost or calculated at a percentage of income therefrom, but he cannot take both for this, too, would be a double deduction.

Since the petitioners' position canont be correct unless the taxpayers are allowed depletion as he allowed it to them, and since such an allowance is expressly forbidden by the statute and the decisions of this

Court, which require that the total allowance as to the share of the oil covered by the oil payment conveyance must go to the assignee of that conveyance, this is further and conclusive proof that the petitioners' whole position is unsound.

VI.

Admittedly correct and long continued practices of the Treasury in closely related situations further demonstrate the unsoundness of petitioners' theory here.

The fallacy in the petitioners' position can be clearly demonstrated by a consideration of other admittedly correct tax practices with respect to oil transactions. The ordinary oil and gas lease entitles the lessee to seven-eighths of all oil and gas produced and places upon him the burden of operating and developing the property at his own cost and risk. Assume that Lessee A in such a lease sells to Investor B an interest in his leasehold entitling B to 1/16th of all oil and gas produced for the life of the property, with a covenant protecting B from all liability for costs of developing and operating. This would be the carving out of an unlimited overiding royalty interest, and would leave A with 13/16ths working interest. Then assume that A conveys his leasehold interest subject to the previously conveyed overriding royalty, to Assignee C for a cash consideration, and in that assignment retains an oil payment to come from 3/16ths of the oil produced and to continue until oil of the value of $100,000

has been received by A, whereupon it is to terminate. Then Assignee C conveys to Investor D a limited overriding royalty or oil payment interest which entitles D to receive 3/16ths of the oil which would otherwise go to C until D has received oil of the value of $100,000, whereupon his interest is to terminate. Let it further be assumed that when each of these transactions took place, the seller or assignor had held the specified interest in the property for more than six months, and that his situation otherwise met the requirements for long-term capital-gain treatment.

Each of the transactions above outlined is an ordinary, commonplace one, and such transactions continuously occur and reoccur in the oil business.

From the beginning, the Treasury has treated and now treats the sale of the unlimited overriding royalty by A to B as productive long-term capital gain to A.[31] If A had a cost in his oil reserve, as distinguished from a cost in equipment, he could allocate a portion thereof against the proceeds which he received for the overriding royalty and the balance would constitute his long-term capital gain. Likewise, when A sold the remainder of his leasehold interest to C, reserving an oil payment, it would be held for tax purposes that he had sold a part of his leasehold and had retained a part represented by his reserved

[31]G.C.M. 22730, Appendix B, p. 88 infra; G.C.M. 22849, Appendix B, p. 117 infra.

oil payment.[32] Here again, he would allocate leasehold costs between the interest sold and the interest retained and treat the difference between the amount received from C and the allocated portion of leasehold cost as long-term capital gain. If A continued to hold his reserved oil payment, amounts received therefrom would be ordinary depletable income and those amounts would not be includable as a part of C's income.[33] If A sold his retained oil payment, or an interest therein continuing for its life, at all times and now, that would be treated as an ordinary sale producing long-term capital gain.[34] Until the change of position dealt with in the previous subdivision of this argument, pages 40 to 46, *supra*, the sale by C of a carved-out oil payment to D would have been productive of long-term capital gain, as would have been the sale by A of an interest in his retained oil payment which did not continue for its entire duration.

Not only, as we have heretofore seen, was the change in position dealt with in the previous subdivision of this argument without judicial sanction or congres-

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[32] *Thomas* v. *Perkins*, 301 U.S. 655; *Fleming* v. *Commissioner*, 82 F. 2d 324; *Ortiz Oil Company* v. *Commissioner*, 102 F. 2d 508; Appendix C, p. 138 infra; G.C.M. 22730, Appendix B, p. 88 infra.

[33] See authorities cited in footnote 32; supra.

[34] The very rulings which purport to deny capital gain treatment to the carving out and sale of an oil payment admit this. See G.C.M. 22849, Appendix B, p. 117 infra; I.T. 4003, Appendix B, p. 125 infra.

sional approval; but upon the assignment-of-future-income question now under consideration, we confidently assert that if an assignment of an oil-payment interest freed from cost, which will expire before the property is exhausted and when oil of a certain value has been received, is an assignment of future income and not a conveyance of an interest in the property, then an assignment of an unlimited overriding royalty which will continue for the life of the property regardless of the amount realized therefrom, and which is equally free of costs and expenses, is even more an assignment of future income as distinguished from a conveyance of an interest in the property.

Reverting to the illustration: After A assigned his oil and gas lease and reserved only an oil-payment interest, he had exactly the same rights therein that D subsequently acquired when an oil payment was carved out by C and assigned to him. If the one is future income, this is equally true of the other. But the Treasury would permit A to sell his retained oil payment and treat the proceeds as capital gain, while denying the corresponding treatment to C who sold the identical interest. Equally strange is the fact that if D, after owning the carved-out payment for six months, had sold his remaining interest, he, too, would have been under Treasury practices, entitled to capital-gain treatment with respect to the proceeds of the sale.

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*See Subdivision III of the argument, pp. 40 to 46 supra.

We believe that enough has been said with respect to the illustrative situations to establish conclusively that petitioners must admit that the distinctions which they presently urge upon this Court are wholly illogical and arbitrary, or that the tax treatment which over a long period of years they have accorded types of transaction other than the carving-out and sale of oil payments has been wholly erroneous.

VII.

Petitioners' brief is premised on many unsound statements and assumptions.

Not only is much of petitions' argument premised on the incorrect assumption that an oil reserve *in situ* is a fruit-producing tree, so that fruit can be recurrently gathered with the tree remaining intact and capable of producing another crop; but it is based upon many other unsound statements and assumptions with which, in closing, we shall deal briefly.

The "increase in the value of property in which the taxpayer had a capital investment" which petitioners consider essential to capital gain treatment (Pets' brief, p. 27) is present in these cases. Clearly, taxpayers had a capital investment in their properties, otherwise they would not have been allowed depletion on any income therefrom. Just as clearly, there had been an enhancement in value; otherwise the conveyances would have produced no gain.

Against petitioners' contention that there was not a sale or exchange (Brief p. 28) is the stipulation that the Fleming transactions were exchanges (R. 161, 166).

Rhodes' Estate v. *Commissioner of Internal Revenue*, 131 F. 2d 513, where the right to receive a declared dividend was assigned, but complete ownership of the stock retained, is typical of the cases cited by petitioners at page 29 of their brief. There was a true assignment of fruit, with a rentention of the tree. How different would have been the result had some of the shares with the right to the unpaid dividend thereon been sold! That is the applicable analogy.

There is no difference, essential here, between an oil-payment interest and a working or royalty interest, as petitioners incorrectly assume (Brief p. 33). The fact that a working-interest is burdened with expense and costs from which the oil payment holder is protected by the terms of his conveyance does not downgrade the oil payment interest. Even this difference is not present when the oil payment comes from a royalty interest. If a retained oil payment is a part of the interest from which it is retained, a carved-out oil-payment is necssarily a part of the interest from which it is carved.

If a carved-out oil-payment merely assigns a contractual right "to receive future proceeds from the

sale of oil" (Pets' brief p. 33) how does this differ from the assignment of an unlimited overriding royalty, which conveys exactly the same rights and which admittedly produces capital gain.

Taxpayers' conveyances were assignments of "capital investment property" (Pets' brief p. 34). Their "capital investment property" was oil *in situ*. Assume that, before an oil payment assignment, a taxpayer's oil reserve was 100,000 barrels and 10,000 barrels were required to discharge the oil payment. After such an oil payment assignment, assignor's ownership would be reduced to 90,000 barrels. The oil payment owner became the true, present owner of the other 10,000 barrels—with all attendant risks and benefits.

That the oil-payment intersts were conveyed for considerations equal to their market value (See petitioners' brief pp. 34-36) reinforces, rather than weakens, taxpayers' contention that the conveyances were bona fide sales or exchanges of property. Petitioners here come very close to espousing the *Slagter* doctrine, which they elsewhere disavow, when they argue that the Flemings "simply used portions of their future oil proceeds to purchase real estate, paying interest on the unpaid portion of the purchase price." "Oil proceeds" are cash; the purchase of real estate for deferred cash payments is never an income producing transaction. Under the same theory, the oil proceeds would be income to the Flemings when the oil was produced, largely in years not before the

Court. This is the *Slagter* doctrine. Its application here would require that substantially all of the tax claims asserted against the Flemings be expunged. Petitioners' argument as to the effect of the Lake transaction (Pets' brief p. 34) has substantially the same error, and, since the effective date of the Lake conveyance was January 1, 1951, the adoption of petitioners' theory would wipe out all taxes asserted against P. G. Lake, Inc. for 1950, the only year before the Court.

Taxpayers' theory will not, as petitioners seem to fear, permit oil producers "to transmute ordinary income into capital gain at will" (Pets' brief p. 36). A continued practice of carving out and selling oil payments, just as a continued practice of selling leases, royalties or any other property would make the practitioner a dealer, and all his resulting gains ordinary income.

Petitioners' argument at pages 38-40 of their brief that the taxpayers' grantees did not make a capital investment when they acquired what is there admitted to be economic interests is directly in the face of the facts and law. The value of the consideration given for the economic interest (property) is the investment therein, just as the purchase price paid for a share of stock is the purchaser's investment therein. Nor need the investment be an "indispensable contribution" to oil production. Otherwise, the purchase for cash of all of an operator's interest in an oil property would

not be an investment in the oil property, for the seller will use the money as he sees fit and will make no contribution to the producing operation in which he has no further interest. The phrase "indispensable contribution" was lifted entirely out of context from this Court's opinion in the *Southwest Exploration* case, 350 U.S. 308.

The depletion deduction is not the only means of recovering a capital investment in an oil property (See pets' brief p. 41). Where the gain is from a sale, rather than from the producing operation, investment is recovered by substracting basis from selling price to calculate taxable gain, just as is true as to sales of other properties. *United States* v. *Ludey*, 274 U.S. 295; *Ortiz Oil Company* v. *Commissioner*, 102 F. 2d 508.

Petitioners misconceive the scope and effect of *Burnet* v. *Harmel*, 287 U.S. 103. In that case, the Court held that the granting of an oil and gas lease by a landowner did not give the landowner the right to treat the cash bonus (advance royalty) received by him as capital gain, for the leasing transaction was not a sale within the capital gain section, even though so classified by local law. It does not stand for the distinction based on the alleged creation of different types of interests which petitioners seek to draw therefrom. If the Treasury thought so, it could not treat the sale of an overriding carved-out royalty as productive of

capital gain (as it does) for, by the same token, the interests are of different types.

The alleged unsubstantiality of the oil payment interests conveyed by these taxpayers, which petitioners seek to establish at pages 48-54 of their brief, is not present. Clearly, substantiality is not to be determined by size or value. The sale of one share of stock by the largest stockholder in the largest corporation in the United States, or the sale of one acre of land by the largest landowner, can qualify for capital gain treatment. The possible life, or economic duration, of the property sold is not a criterion by which the applicability of the capital gain provisions is to be determinated. Otherwise, if one sold an ordinary corporate bond maturing in a few years, it would not be the sale of a capital asset. As the Court below pointed out in distinguishing our cases from *Commissioner* v. *Hawn*, 231 F. 2d 340, substantiality, in the determination of ownership, should be determined by ascertaining who possesses the essentials of the bundle of rights which everywhere make up true ownership.[36] Whomsoever has all of those rights has substantial rights, true ownership. Here, each oil payment grantee had all the rights incident to ownership. He could sell, mortgage or donate his interest. It would be

[36]Further it is difficult to see how the building contractor with whom Hawn dealt made the investment in Hawn's oil payment, which everyone recognizes is essential to the acquisition of a depletable economic interest (ownership) therein. If the contractor acquired no such depletable interest there could have been no sale—a requisite to capital gain.

transmitted at his death. The loss from the destruction of the property without fault would fall solely on him. It could be taken for his debt, but not for the debt of another. He could not be required to account for receipts therefrom or for any other transaction with respect thereto. That he could not directly participate in the producing operation no more lessened his ownership than would have been the case had the interest been an unlimited—rather than a limited—overriding royalty or an oil payment interest.

These factors, coupled with the length of pay-out of the oil payments conveyed by these taxpayers, render cases such as *Harrison* v. *Schaffner*, 312 U.S. 579, *Helvering* v. *Clifford*, 309 U.S. 331; *Helvering* v. *Stuart*, 317 U.S. 154, and the others cited (practically all of which involve donative assignments) so clearly inapplicable that they will not be discussed in detail. *Cf. Blair* v. *Commissioner*, 300 U.S. 5.

Petitioners' brief (p. 51) assumes that the time of pay-out of oil payments—such as those involved—can be accurately forecast. It is merely a coincidence that, for example, the estimated time of the Lake oil payment pay-out was accurate. Assuming that the quantity of oil in the reserve can be estimated with fair accuracy, two other factors are necessarily unpredictable—price and "allowable". The average price of oil in the East Texas Field—where the Lake properties were located,—has varied from the beginning of production in that field (1930) to 1956, from 56 cents

per barrel to $2.90 per barrel. For many years the "allowable" from non-marginal wells has been 20 barrels per day, but this was further limited by the number of "producing days" permitted by the Railroad Commission of Texas. The average number of permitted producing days in each year from 1937 to September, 1956, varied from 28 days per month to 15 days per month, and is now 10 days per month. With the variations in price similar to those mentioned, and similar variations in permitted "producing days", it would have been possible for the Lake payment to have extended for twenty years or more, and for some of the Fleming payments to have extended far beyond any reasonable estimate of the life of the properties to which they pertained. These inherent hazards were the sole risk of the oil-payment grantees, as to which their only protection was the "interest factor" which, of course, is not actually interest, but only a flexible measure of the amount of oil to which the oil-payment grantees were entitled.

CONCLUSION

For the reasons stated, it is respectfully submitted that this Court should hold that the exchanges involved in the Fleming case did not give rise to recognizable gain under *Section 112(b)(1)* of the Internal Revenue Code of 1939; and that both judgments below should be affirmed with respect to the capital gain issue.

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[31] Mineral Year Book published by the United States Bureau of Mines.

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APPENDIX A

Internal Revenue Code of 1939:

Sec. 23(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions,

on the basis of the trust income allocable to each.

For percentage depletion allowable under this subsection, see section 114(b), (3) and (4).

* * * *

Sec. 112—Recognition of Gain or Loss.

(b) Exchanges Solely In Kind.—

(1) Property Held For Productive Use or Investment.—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

* * * *

Sec. 114(b)(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents

or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

* * * *

Sec. 117. Capital Gains and Losses.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in sec-

tion 23 *(l)*, or real property used in his trade or business;

(C) a copyright; a literary, musical, or artistic composition; or similar property; held by—

(i) a taxpayer whose personal efforts created such property, or

(ii) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property; or

(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such

gain is taken into account in computing gross income;

* * * *

(c)(2) *Other taxpayers.*—If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12 (or, in the case of certain tax-exempt trusts, in lieu of the tax imposed by section 421), a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

(A) A partial tax shall first be computed upon the net income reduced by an amount equal to 50 per centum of such excess, at the rates and in the manner as if this subsection had not been enacted.

(B) There shall then be ascertained an amount equal to 25 per centum of the excess of the net long-term capital gain over the net short-term capital loss. In the case of any taxable year beginning after October 31, 1951, and before November 1, 1953, there shall be ascertained, in lieu of the amount computed under the preceding sentence, an amount equal to 26 per centum of the excess

of the net long-term capital gain over the net short-term capital loss.

(C) The total tax shall be the partial tax computed under subparagraph (A) plus the amount computed under subparagraph (B).

* * * *

(j) *Gains and Losses from Involuntary Conversion and from the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23*(l)*, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described

in subsection (a)(1)(C). Such term also includes timber or coal with respect to which subsection (k)(1) or (2) is applicable and unharvested crops to which paragraph (3) is applicable. Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

* * * *

(2) *General rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sale or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales

or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsection (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

* * * *

(3) *Sale of land with unharvested crop.*— In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted as described in paragraph (2)) at the same time and to the same person, the crop

shall be considered as "property used in the trade or business".

* * * *

Income Tax Regulations 118:

39.23(m)-1. Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.

(a) Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

(b) Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. * * * An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral

deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

* * * *

(e) As used in sections 114(b)(3) and 114(b)(4)(A) and Section 39.23(m)-1 to 39.23(m)-19, inclusive, the term "gross income from the property" means the following:

(1) In the case of oil and gas wells, "gross income from the property" as used in section 114(b)(3), means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. If the oil and gas are not sold on the property but are manufactured or converted into a refined product prior to sale, or are transported from the property prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price (as of the date of sale) of the oil and gas before conversion or transportation.

* * * *

39.23(m)-4. Computation of depletion based on a percentage of income in case of oil and gas wells. Under section 114(b)(3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27-1/2 percent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property" see Section 39.23(m)-1(e) and (g)). In no case shall the deduction computed under this section be less than it would be if computed upon the cost or other basis of the property provided for in section 113.

* * * *

Paragraph 39.112(b)(1)-1. Property Held for Productive Use in Trade or Business or for Investment.

(a) As used in section 112(b)(1) the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not

material, for such fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

(b) No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose, or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate, or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

APPENDIX B

G. C. M. 12118

C. B. XII-2, p. 119

RevenueAct of 1928

An unlimited conveyance for a cash consideration of the lessor's reserved royalty under an oil and gas lease, or a fractional interest therein, may be treated as a sale of a capital asset within the purview of the capital gains provision (section 101) of the Revenue Act of 1928, provided the interest in the property sold otherwise falls within the definition of the term "capital assets" as defined in section 101.

An opinion is requested whether, in view of the decision of the Supreme Court of the United States in the case of *Burnet* v. *Harmel* (287 U. S. 103, Ct. D. 611, C. B. XI-2, 210), an unlimited conveyance for a cash consideration of the lessor's reserved royalty under an oil and gas lease, or a fractional interest therein, may be treated as a sale of a capital asset under section 101 of the Revenue Act of 1928.

In *Burnet* v. *Harmel*, *supra*, the Supreme Court of the United States held that where an owner in fee executes *an oil and gas lease* for a specified term and as long thereafter as oil and gas shall be produced by

the lessee, in consideration of a cash bonus and stipulated royalties measured by the production of oil and gas, the bonus and royalties are not "gain from the sale or exchange of capital assets" within the meaning of section 208(a)1 of the Revenue Act of 1924, but are taxable as ordinary income. The court said that irrespective of any particular characterization of the payments in the local law, for the purpose of applying the capital gains provision the Revenue Acts of Congress have their own criteria, and when judged accordingly an oil and gas lease is not to be described as a "sale" of the mineral content of the soil, using the term either in its technical sense or as it is commonly understood. Referring to its prior decisions under the corporation excise tax law of 1909, the Supreme Court said that "they established, for purposes of defining 'income' in a tax measured by it, that payments by lessees to lessors under mining leases were not a conversion of capital, as upon a sale of capital assets, but were income to the lessor, like payments of rent," citing *Stratton's Independence, Ltd.*, v. *Howbert* (231 U. S. 399); *Goldfield Consolidated Mines Co.* v. *Scott* (247 U. S. 126); *Stanton* v. *Baltic Mining Co.* (240 U. S. 103); *Von Baumbach* v. *Sargent Land Co.* (242 U. S. 503); and *United States* v. *Biwabik Mining Co.* (247 U. S. 116). The decision in *Burnet* v. *Harmel*, supra, confirmed a line of opinions of the Board of Tax Appeals, including *Henry L. Berg et al* v. *Commissioner* (6 B. T. A. 1287); *John T. Burkett* v. *Commissioner* (7 B. T. A. 560); *James R. Parkey et al* v. *Commissioner* (16 B. T. A. 441); *Henry Harmel* v. *Commissioner* (19 B.

T. A. 376); and *W. P. Ferguson* v. *Commissioner* (20 B. T. A. 130).

The Board of Tax Appeals has held that a conveyance by deed, for a cash consideration, of an interest in the lessor's mineral rights, subject to an existing oil and gas lease under which the lessee has the right to operate for a term of years or so long as oil or gas is produced from the land by the lessee, constitutes a sale of a capital asset within the capital gains provision (section 206) of the Revenue Act of 1921. (*J. E. Murphy* v. *Commissioner*, 9 B. T. A. 610, C. B. VIII-2, 37, and *J. D. Reynolds* v. *Commissioner*, 10 B. T. A. 651, C. B. VIII-2, 44.) A fractional interest in the royalty reserved under the lease was considered to have passed to the grantee as an incident of the conveyance in each of the cases cited.

The Board has also decided that the conveyance for a cash consideration of a fractional interest in a reserved royalty as such is a sale of property within the meaning of section 202 of the Revenue Act of 1921, and that the grantor of such an interest is not entitled, in determining taxable income, to apply against the consideration received a depletion deduction based upon the discovery value depletion base provided for in section 214(a)10 of the Revenue Act of 1921. (*Appeal of Anna Taylor*, 3 B. T. A. 1201; *J. M. Hudson* v. *Commissioner*, 14 B. T. A. 983.) These decisions of the Board sustained the position of the Commissioner. If such a conveyance of a reserved royalty, or a fractional interest therein constitutes a sale of property for

the purposes of section 202 of the Revenue Act of 1921 it also qualifies as a sale of a capital asset under section 206 of that Act, assuming that the reserved royalty is an interest which the *lessor has owned for more than two years prior to the conveyance.*

The Bureau has held following the Board's decision in the case of *J. E. Murphy* v. *Commissioner*, supra, that a conveyance by royalty deed of a fractional interest in the oil, gas and other minerals under certain lands, and in the royalty rights in respect thereto, without limitation as to duration of time is "a sale of capital assets," and that the provisions of section 208 of the Revenue Act of 1926 are applicable to such a sale. (I. T. 2524, C. B. IX-1, 199.) In such a case the fractional interest in the reserved royalty passes to the grantee as an incident of the grant of a fractional interest of the lessor's reserved oil and gas rights subject to the lease.

As heretofore indicated, the case of *Burnet* v. *Harmel*, supra, establishes the principle that all payments from lessee to lessor under an oil and gas lease are income from the use of the land and are not gain from the sale or conversion of capital assets. This rule should be applied in all cases where the instrument of grant may be classified properly as a lease. *This office is of the opinion, however, that in the case of an unlimited conveyance for a cash consideration of the lessor's reserved royalty under an oil and gas lease, or of a fractional interest therein, as in the cases of J. E. Murphy v. Commissioner, supra, and the Appeal of*

Anna Taylor, supra, the conveyance may be treated as a sale of a capital asset within the purview of the capital gains provision (section 101) of the Revenue Act of 1928, provided the interest in the property sold otherwise falls within the definition of the term "capital assets" as defined in section 101. (Emphasis supplied)

G. C. M. 22730, C. B. 1941-1, p. 214

INTERNAL REVENUE CODE AND PRIOR REVENUE LAWS

Status of oil and gas leasing transactions for Federal income tax purposes, including review of controlling cases and discussion of issues relating to acquisition and assignment of interests in oil and mineral properties, the division of income derived from the sale of the product among the parties entitled to share therein, and the depletion allowances granted such parties.

An opinion is requested with respect to the status of oil and gas leasing transactions for Federal income tax purposes, the acquisition and assignment of interests in oil and mineral properties, the division of income derived from the sale of the product among the parties entitled to share therein, and the depletion allowances granted such parties.

The following supposititious case presenting the questions involved may be stated for convenient consideration. A, as a fee owner of oil lands, leased the lands to B in consideration of a cash payment of $100,000, an additional $100,000 payable out of one-sixteenth of the oil and gas if, as, an when produced, and a one-eighth royalty interest. B then assigned his leasehold interest to C in consideration of a cash payment of $200,000, and an additional $100,000, payable only out of one-sixteenth of the oil and gas if, as, and when produced. C assigned one-half of the lessee interest to D, who agreed to develop and operate the property, to advance C's share of the funds necessary for development costs and operating expenses, to sell all the oil produced and saved and credit C with one-half of the proceeds until all advances were fully recouped, and thereafter to operate the property and pay one-half of the proceeds from the sale of all oil produced, less one-half of the operating expenses, to C, who was not personally liable for any costs or expenses incurred or advances made. E drilled an oil well under an agreement with D entitling E to have delivered to his credit one-eighth of all the first oil and/or gas if, as, and only when the same is produced, saved, and marketed from the land until he received the sum of $25,000. *Also, F paid D the sum of $15,000, which D convenanted to use in developing the property, and D agreed to pay F the sum of $25,000, payable out of one-eighth of the oil and/or gas, if, as, and only when the same is produced, saved, and marketed from the leased land.*

In *Lynch* v. *Alworth-Stephens Co.* (267 U. S. 364, T. D. 3690, C. B. IV-1, 162 (1925)) and cases therein cited, the United States Supreme Court, though it expressly recognized the hardship involved in treating all proceeds from the extraction and sale of ore as ordinary income in view of the fact that mining operations reduce the value of property interests in mineral deposits, made it clear that such reduction in value is not depreciation but depletion, and that the capital investments in minerals of both the lessor and the lessee are returnable to them tax-free only through depletion deductions expressly granted by statute. (See also *Helvering* v. *Mountain Producers Corporation*, 303 U. S., 376, Ct. D. 1321, C. B. 1938-1, 343, wherein the Court stated that the depletion allowance rests upon legislative grace.)

Though the Revenue Act of 1916 did not expressly provide for the allocation of depletion between the parties in interest, the Court in the Alworth-Stephens case regarded both the lessor and the lessee of mining property as owning valuable property rights in the mineral in place which were reduced in value through the extraction of ore, and it held the total depletion allowable was allocable between the lessor and the lessee in proportion to the interests of each severally considered.

Subsequent decisions hold that the incidental exhaustion of natural deposits through the production and sale of oil or minerals is not a sale or conversion of capital assets allowing cost or basic value to be re-

covered tax-free. Further, a sale of capital assets is not involved in a lease agreement in which the lessor, in consideration of a bonus or lump sum cash payment made at the time the lease was executed (hereinafter referred to as a "bonus") and stipulated royalties measured either by a percentage of production under the lease or by a stated sum per unit extracted and sold (hereinafter referred to as "royalties") which are payable over the entire lease life, grants a lessee the right to enter upon and use the land for purposes of exploitation. (See *Bankers Pocahontas Coal Co.* v. *Burnet*, 287 U. S., 308, Ct. D. 618, C. B. XII-1, 272 (1933), and *Burnet* v. *Harmel*, 287 U. S. 103, Ct. D. 611, C. B. XI-2, 210 (1932), involving ordinary royalties paid a lessor of coal lands on the basis of a fixed amount per ton mined, and a bonus paid the lessor of oil lands, respectively.) The Court thus not only recognized that royalty payments like rental payments are ordinary income to the lessor, but drew an analogy between cash bonus payments made upon the execution of an oil and gas or mining lease and a substantial payment received in the first year by a lessor in any other type of lease for purposes of classifying such bonus payments as ordinary income rather than proceeds from the sale of capital assets.

Such classification of bonus payments does not depend upon whether the local law regards the agreement between lessor and lessee as a lease or a sale of natural resources in place. In *Palmer* v. *Bender* (287 U. S., 551, Ct. D. 641, C. B. XII-1, 235 (1933)) the Court refused to distinguish between lessors and sub-

lessors or assignors of leasehold interests who, by stipulation for royalty payments, reserve an interest in production coextensive with the leasehold life. The taxpayer therein was a member of several partnerships, each of which had acquired an oil lease, had discovered oil, and had then assigned the lease to a third party in consideration of a bonus payment, a future payment of a stated sum to be made out of one-half of the first oil produced and saved (which type of payment will hereinafter be referred to as an "oil payment"), an interest which does not by its terms extend throughout the lease life, and an additional "excess royalty" of one-eighth of all of the oil produced and saved. The Court held that the bonus payment, the oil payments, and the royalty payments were ordinary income to the sublessor or assignor subject to the depletion allowance, rather than proceeds from the sale of capital assets. The Court refused to distinguish between leases governed by varying State laws which apply different rules as to when technical title to oil and gas passes to the lessee, on the ground that the economic consequences to the lessor are the same in all cases—i.e., the value of his interest is lessened by the extraction of oil. The Court stressed the general view that all persons having a right to share in the oil produced or the proceeds from its sale, irrespective of the legal form of their interest in the property, have an economic interest in the oil and gas in place to which the depletion provisions are applicable, the language of the statute, providing that the depletion allowance shall be allocated between lessor and lessee, being held to be broad enough to provide, at

least, for every case in which the taxpayer has acquired by investment any interest in the oil in place, or has secured, by any form of legal relation, income derived from the extraction of oil to which he must look for a return of his capital. The opinion states that a lessor, or sublessor or assignor, who stipulated for the payment of future royalties in kind from the oil produced and saved, had retained an economic interest in the oil and gas in place entitling him to depletion deductions against cash bonus payments as well as proceeds from his share of the oil. The opinion inplies that the proceeds from the sale of any share in the oil produced are income subject to depletion in the hands of the one entitled to such share. Further, the Court speaks of the oil and gas in place as a reservoir of the capital investments of the several parties entitled by agreement to share in the oil and gas produced under the lease.

Such language indicates that the Court regarded the contracts between the interested parties as dividing the property rights in oil and gas in place in accordance with their respective shares upon production. That is, the lessor, by lease terms reserving royalties, merely grants to the lessee exclusive exploitation privileges, retaining as his share of the oil and gas in place that portion thereof which, freed of the burdens of development and operating costs, has a value equivalent to the value of the entire interest subject to such burdens, and, therefore, like the lessor of an ordinary lease reserving rent, is regarded as not having disposed of a capital asset. The remaining fractional interest

in oil and gas in place becomes the share of the lessee's working or operating interest which carries the risks and burdens attending exploitation. If the lessee in turn subleases or assigns the working interest, reserving a royalty share, he acquires a status comparable to that of a lessor with respect to the share retained, any further burden of exploitation being passed on to the sublessee or assignee with an agreed share in the oil and gas produced. So considered, the view that a lessor, or a sublessor or assignor, parts with no capital interest, though the lessee, or sublessee or assignee, acquires a capital interest upon the execution or assignment of a lease, presents no logical difficulties, as the lessee interest, though it may have great potential value, ordinarily becomes valuable only upon investment by the lessee in exploitation or by reason of discovery. Under this theory, the lessee does not pay rent to the lessor by royalty payments but, instead, divides the product or the proceeds realized therefrom with him. Thus, in the classification of royalty payments as "rent" to the lessor, the term is employed as denoting a sharing by the lessor for the use of his land rather than as an amount owing and paid by the lessee. A cash bonus, though termed an advance royalty payment, paid to a lessor without regard to production and often in a year when there is no production, is not a division of products or proceeds therefrom. Nor, as already noted, does it represent proceeds from the sale of a capital asset to a lessor reserving a royalty interest. The lessor does not sell an interest to the lessee. Instead, the lessee acquires an

interest by assuming the obligation to develop and operate the property.

The analogy between the bonus payment accompanying a mineral lease and a large payment made in the first year of any ordinary lease, to which the Court resorted to characterize the bonus payment as ordinary income as distinguished from capital gain to the lessor, does not establish an identity of character in the two types of payments for Federal income tax purposes. An oil or mineral lease differs from an ordinary land lease in that it contemplates severance and disposition of valuable mineral deposits that normally represent a large percentage of land values. Further, the allowance of depletion deductions to the lessor, which serve to offset his bonus income and reduce the basis of his interest, establishes the distinction between such payments by treating the bonus payment upon an oil or mineral lease as, in part, a tax-free return of the lessor's capital investment in mineral in place. As the mineral in place is a reservoir of the capital investments of the parties returnable through the depletion allowance, and as the bonus payment results in a reduction in the lessor's capital investment to the extent of the depletion allowable thereon, if follows that such payment is a contribution by the lessee to such reservoir of capital investments which is substituted for the capital thereby withdrawn by the lessor. Such shifting of capital investment is attended by a corresponding shift in the value of the respective capital interests or share rights of the parties. That is, a bonus payment diminishes the value of the lessor's

mineral interest by reducing his royalty share in future production. The depletion allowance on his bonus income is designed to compensate him for such diminution in value of his interest thereby sustained. Correspondingly, the bonus payment enhances the value of the lessee's interest by giving him a larger share of the minerals produced, or the proceeds therefrom, by reason of his bonus investment.

It will be noted that the analogy between a bonus payment made upon the execution of an oil or mineral lease and a large rental payment made in the first year of any ordinary lease, upon which the Supreme Court based its conclusion that such bonus payment was ordinary income in the nature of an advance royalty payment subject to the depletion allowance rather than proceeds from the sale of a capital asset, is not available to permit of like treatment of a cash payment made where no royalty right is reserved by the payee. Royalty rights represent a share in all of the oil or mineral in place, and a bonus payment which reduces the royalty and, therefore, the lessor's capital interest in every unit of oil or mineral content may properly be termed an advance royalty. *Unlike ordinary rights to rent or royalty, oil payment rights represent share rights in only a portion of the oil or mineral content of the land. When the stipulated payments are made, the payee's interest in oil or mineral expires. A cash payment made upon the execution of an instrument stipulating only for oil payments is, therefore, regarded not as an advance royalty payment but as proceeds from a sale in which the payee disposed of his economic*

interest in oil or mineral in place, less the fraction thereof represented by the oil payment rights reserved by him. (See *Commissioner* v. *Fleming*, 82 Fed. (2d), 324.)

It thus appears that (1) agreements to pay royalties measured by a fraction of the mineral product or the proceeds therefrom, or by a stated sum per unit extracted and sold, in effect divide the proceeds from production, and (2) cash bonus payments representing advance royalty payments effect a substitution in the reservoir of capital investments of lessee invested capital for invested capital withdrawn by the lessor in the amount of depletion sustained by him, thereby giving the lessee a larger share upon production and, consequently, a greater interest in natural deposits in place than he would have had if there had been no cash bonus payment. A cash payment representing proceeds from the sale of an economic interest also accomplishes a substitution of payor invested capital for payee invested capital. The payee in such a case realizes capital gain or loss measured by the difference between cost allocable to the interest sold and the proceeds received.

The stated basic concepts of income and the attending depletion allowances apply to depletion provisions basing allowances on percentages of gross income from the properties as well as to the provisions of the earlier Acts granting allowances based upon cost or value at March 1, 1913, or upon discovery value. In *United States* v. *Dakota-Montana Oil Co.* (288 U. S., 459, Ct.

D. 655, C. B. XII-1, 243 (1933)), treating capitalized intangible costs of development as returnable through the depletion allowance, the Court pointed out that there is "no ground for supposing that Congress, by providing a new method for computing the allowance for depletion intended to break with the past and narrow the function of that allowance." The Court said that the "reasonable inference is that it did not and that depletion includes under the 1926 Act precisely what it included under the earlier Acts.". In *Herring* v. *Commissioner* (293 U. S., 322, Ct. D. 904, C. B. XIV-1, 303 (1935)) the Court stated that the nature and purpose of the allowance based on a percentage of income are the same as in the case of the allowance based on cost, and allowed a lessor receiving an advance royalty or bonus payment upon the execution of an oil and gas lease a percentage depletion allowance thereon. The fact that such an allowance is in anticipation of production was stated to be no more persuasive under the percentage depletion provisions than it was under the depletion provisions of the earlier Acts.

Aside from such bonus payment to a lessor or assignor, the term "gross income," as used in the phrase "gross income from the property" in the percentage depletion provisions, means the same as "gross income" in the provisions generally defining income, with the qualification that the phrase "gross income from the property" in the depletion provisions is confined to the gross income from the extraction of oil rather than gross income from the tract of land in all its uses. (See *Helvering* v. *Twin Bell Oil Syndicate*,

293 U. S., 312, Ct. D. 905, C. B. XIV-1, 253 (1935), involving an assignee of an oil and gas lease which was obligated to pay royalties in cash or in kind totaling one-fourth of the oil extracted.) The taxpayer-assignee in *Helvering* v. *Twin Bell Oil Syndicate, supra,* contended that the entire gross income from production of oil and gas was its gross income from the property and claimed the deduction of 27½ per cent thereof as its allowance for depletion. The Court held that the income from production and sale of the products and the depletion allowance thereon, however measured, must be apportioned between lessor and lessee. Thus the Court confirmed the implications of the earlier cases involving lessors and sublessors or assignors by applying the basic concepts as to (1) gross income from production, and (2) depletion allowances and their division between the respective parties interested.

In the last-cited case the Court, in effect, pointed out that an agreement to pay royalties represents a sharing arrangement between the parties by expressing the view that the provision of a later Act, section 114 (b) 3, *Revenue Act of 1932,* which expressly excludes royalties paid or incurred in respect to the property from the lessee's gross income from the property, was merely declaratory of existing law. This implication as to division between the parties by means of royalty payments was confirmed and extended to include divisions effected by agreements to make oil payments in *Thomas* v. *J. J. Perkins et al* (301 U. S., 655, Ct. D. 1237, C. B. 1937-1, 162), wherein proceeds from the share of oil reserved by an assignor were held

not to be income to the assignee. In that case, lessees of oil and gas leases assigned the leases for $395,000, payable out of one-fourth of the oil produced free of any share of development expense or any other burden. The Palmer case, *supra*, was cited as supporting the view that the oil payment interest retained by the assignors gave them ownership of the stipulated share of the oil and entitled them to the income therefrom and the depletion allowance thereon. The *Twin Bell Oil case, supra*, was cited as holding that it is immaterial whether the lessor, or sublessor or assignor, is to receive the royalty in oil or the proceeds from the sale of his share of such oil by the lessee.

The cited cases show that the stated basic principles apply equally to mineral deposits and to oil and gas. Like issues arise in the oil and mineral cases which are cited interchangeably in the evolution of the applicable rules. *The parties entitled to share in oil or mineral extracted, or the gross proceeds therefrom (including the parties to a lease providing for royalty payments of stated amounts per unit mined), have economic interests in the oil or minerals in place. That is, they, as owners of the rights in oil or other mineral in place, share the income from production, and the depletion allowances thereon are regarded as designed to permit tax-free recovery of at least their capital investments in such property rights.* (See also the *Mountain Producers case, supra*, wherein the royalty payable by the producer was measured by a per unit price based on current gasoline prices.)

It will be noted that the persons entitled to oil payments or royalty payments, which the above-cited cases have characterized as the owners of economic interests in oil or mineral in place, by the terms of the agreements from which these rights arise, are assured of a share if there is production of oil or mineral. *J. Steve Anderson et al* v. *Helvering* (310 U. S., 404, Ct. D. 1456, C. B. 1940-1, 108) confirms this view. The obligation there involved was not an ordinary oil payment right, as it was payable out of proceeds from oil produced or proceeds from resale of the properties. Payment out of proceeds from resale would liquidate the obligation and terminate the right to share in production income.

Assurance of a share upon production marks ownership of an economic interest in oil and gas in place. Division of production income and the attending depletion allowances between owners of economic interests necessarily exclude all others. The right to share in production or gross income therefrom should not be confused with a contractual right to purchase and process a product of the mine or well, even though such processing incidentally aids production and is done under a sharing of the processed product with the producers. In *Helvering* v. *Bankline Oil Co.* (303 U.S., 362, Ct. D. 1323, C.B. 1938-1, 306) the taxpayer contracted with producers of oil and gas for the treatment of wet gas to produce gasoline. The taxpayer agreed to install and maintain necessary pipe lines and connections from casingheads or traps at the mouth of the well to its plant, and the producers agreed

to deliver the natural gas from which the taxpayer was to extract the gasoline and return part of the dry gas to the well to be used therein for pressure purposes. The taxpayer agreed to deliver one-third of the gasoline extracted or the gross proceeds from the sale of such share. The Court held that the taxpayer was a mere purchaser of the gas produced from the well and not a producer of gas having a depletable economic interest in mineral in place. It should be noted that the taxpayer's capital investment was in equipment facilitating delivery of the gas produced rather than in equipment for production of gas, and that its function was not production of gas but the processing of gas. The *Mountain Producers case, supra*, is distinguishable in that the refining company purchaser therein was a producer and was required to make the capital investments necessary to production that gave the producer an economic interest in oil and gas in place.

Similarly, a right to share in production, or the gross income therefrom, is very different from the right to share in the net income of the producer (a right measured not by production of mineral, as such, but by the degree of success in operation of such a right owned by another). (See *Helvering* v. *Elbe Oil Land Development Co.*, 303 U.S., 372, Ct. D. 1322, C.B. 1938-1, 293, as interpreted by the *Anderson case, supra*, and *Helvering* v. *O'Donnell*, 303 U.S., 370, Ct. D. 1324, C.B. 1938-1, 337.) In the *Elbe case, supra*, the rights in oil properties and equipment were trans-

ferred for a stated consideration payable in annual installments, irrespective of production from the properties transferred, plus one-third of the net profits derived from operation of the properties by the purchaser after it had been reimbursed from oil and gas proceeds for all expenditures made by it in the acquisition, development, and operation of the properties. The interest of the seller was thus limited to a right to share in net income after recoupment of capital expenditures rather than gross proceeds from production. In the *O'Donnell case, supra*, stock of a corporation owning oil property rights was sold to another corporation (which was to take over in liquidation of the oil properties of the first corporation and operate them) for a one-third share of the net profits derived from the operation of the oil properties. In both cases, the Court held the transfers to be sales, and that in neither case did the transferor have a depletable economic interest in the mineral in place after the transaction had been completed.

It seems clear that the right to share in production, or the gross proceeds therefrom, which distinguishes ownership of depletable economic interests in oil or mineral in place from nondepletable economic advantages, including contractual rights to purchase the product or to share in net income, does not depend upon legal title to the oil and gas or mineral deposits. (*Burnet* v. *Harmel, supra*, and *Palmer* v. *Bender, supra.*) Also, as noted above, in the Palmer case, technical legal description or characterization of the

right was treated as immaterial, the Court saying that the owner of a depletable economic interest includes any taxpayer who "has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital." In the *Anderson case, supra*, the Court in discussing the *Perkins case, supra*, involving an oil payment right reserved upon assignment, said the "decision did not turn upon the particular instrument involved, or upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for payments . . . that type."

Such language seems as applicable to grants as to reservations of economic interests, as the formalities of the conveyancer's art are quite as exacting in the reservation of interests as in the grant of interest. If, as the Court indicates, the mere stipulation for oil payments to a person having an investment or capital interest in oil properties amounts in effect, to a retention of a depletable economic interest in oil in place to the extent of such oil payments, then it would seem to follow that an agreement entitling one making an investment (thereby acquiring a capital interest) in such properties to such payments would give him a corresponding depletable economic interest therein. The point assumes importance in view of the many contracts entered into by owners of lessee interests with well drillers to drill wells, equipment dealers to furnish equipment, and investors to furnish

money for use in developing the leased property in return for agreements to make stated payments out of a share of the oil. By such arrangements, a lessee commonly lessens his own investment and the risks and burdens attending development by agreements to share the investment obligation and the proceeds of production. The Lessee or assignee, like the lessor or assignor who retained a share interest in production having a value equivalent to that of the lessor's prior interest but passed on to the lessee the investment obligations and risks that attend development for a share in production, has parted with no capital interest but has merely in turn given another a right to share in production in consideration of an investment made by such other person. If the driller or equipment dealer is making an investment by which he acquires an economic interest in oil and gas in place, expenditures made by him represent capital expenditures returnable tax-free through the depletion allowance rather than by way of expense deduction, and the oil payment rights acquired do not represent payment in property for services rendered or supplies furnished. Similarly, one who, in return for an oil payment right, furnishes money which the lessee is pledged to use in developing the property would be regarded as making an investment representing an addition to the reservoir of capital investments in oil and gas in place (as distinguished from the purchase of an oil payment right from the lessee wherein there is no such pledge to invest the proceeds in development and the buyer's capital investment would replace the lessee's capital

investment allocable to the interest sold). Such a transaction, involving a pledge to use the money furnished in developing the property, is distinguishable from a sale the proceeds of which are unqualifiedly received by the seller. This view seems to accord with the realities of such transactions. In none of such cases has the lessee parted with a capital asset, and the investments involved are not his investments.

The stated principles seem applicable irrespective of whether there are words purporting to convey an interest in the oil in place involv in the oil payment rights. Both the practical and economic consequences of provisions for payments of this type are identical in either case. *It seems generally agreed that, irrespective of conveyancing formalities, a right to a share of the oil produced carries with it a corresponding interest in the oil in place.* That rights to share in the oil produced are analogous to rights to share in gross proceeds derived from the sale of oil produced has been repeatedly stated by the highest Court. It would seem to follow that a right to a share of the proceeds from the sale of oil produced would give the payee ownership of a corresponding depletable economic interest without regard to conveyancing formalities.

It thus appears that the controlling cases regard capitalized development costs as representing investments returnable through the depletion allowances, whether the total development investment is made by a landowner who elects to develop the property him-

self and take all the oil or mineral or is shared by a number of investors who, by contractual arrangements between themselves, agree to divide the resulting oil or mineral product or the proceeds from the sale of such product. If the latter, the division of oil, or the gross income therefrom, determines the economic ownership of oil or mineral in place as well as the gross income and attending depletion allowances. Under this test, the form of the contracts dividing the product or the gross income therefrom, or the legal phraseology or devices utilized to accomplish the division, are immaterial. For example, an instrument purporting to be a "lease" of oil or mineral lands, which gave a "lessee" a right to explore for and produce all the oil or mineral found thereon and required the "lessee" to pay the "lessor" only a share of the net profits derived from the operation (as distinguished from a share of the product or the proceeds from the sale of the product), would leave the "lessor" without a depletable economic interest in the oil or mineral in place, and a "bonus" payment, if any, made upon the execution of such instrument would represent proceeds from the sale of a capital asset. Such results accord with the realities of the test supplied. Under such an agreement, the lessee may exhaust a substantial oil or mineral content with little or no realization of net profits, in which event the lessor will receive little or nothing under the contract. That being true, the lessor in effect has not retained an interest in the oil or mineral content.

Similarly, the Federal income tax status of a "carried interest" depends upon the extent to which such interest in effect represents a right to share in gross income as distinguished from net income derived from the operation. In *Reynolds* v. *McMurray* (60 Fed. (2d), 843, certiorari denied 287 U.S., 664, Ct. D. 616, C.B. XII-1, 198 (1933)), McMurray was the owner of an undivided interest in oil leases, subject to a contract with the Ohio Oil Co., which also owned an undivided interest in such leases. Under the contract, the parties agreed that the Ohio Oil Co. was to manage, control, develop, and operate such leases and pay all costs incident thereto and charge McMurray's undivided interest with its proportionate part thereof; that it should market the oil and gas produced and account to McMurray for his proportionate part thereof; that it should be reimbursed by McMurray from the proceeds derived from the sale of his proportionate part of the oil and gas, to be effected by crediting McMurray's account with the Ohio Oil Co., on the 1st of each month, with the proceeds derived from the sales during the month preceding of his proportionate part of the oil and gas; and that it should make monthly remittances to him of his proportionate share of any proceeds remaining after deducting the amounts due it for expenditures made by it for him.

The economic or practical effect of such contract was to turn over the leasehold estate to the Ohio Oil Co. for development and the extraction and sale of the product. Though McMurray retained legal title to

his undivided interest under the lease, he contracted away the only right granted thereby—i.e., to extract and sell the oil content of the leased land. Thereafter, the development and operation of the property were carried on by the oil company on its own behalf and not as a joint operation by co-owners. Proceeds from the sale of oil were not divided between the parties. Charges and credits in the account between the parties did not reflect actual obligations between them. Rather, they were merely factors in computing the net income payments which were all McMurray could ever become entitled to under the agreement, regardless of how much oil was extracted and sold from the leased premises. McMurray's interest was converted into a mere contractual right to share in any net income derived from the sale after recoupment of all capital invested by the oil company. The oil company was obligated to make all of the investment necessary to develop the property and to pay all the costs of operation, and it could look only to the proceeds from the sale of the lessee share of oil and gas produced for reimbursement of its capital expenditures and operating expenses. The oil company assumed all the risks and burdens attending development and operation, and it was entitled under the contract to the entire lessee share of production which was the only source from which its capital and expenses could be recouped. Accordingly, such investment was in an economic interest in oil and gas in place measured by the lessee share of production. It is, therefore, the opinion of this office that the decision in that case, holding that

the proportionate share of the proceeds from the sale of oil ostensibly credited to McMurray was constructive income to him, is out of harmony with the above-described test of ownership of income from production, and it should no longer be followed. In cases where, after recoupment of such charges or so-called advances to the "carried interest", the interest ceases to be a "carried interest" and the owner thereof becomes entitled to a share in the oil, or the gross income therefrom, and liable for his share of costs and expenses, he should be regarded as retaining under the contract an economic interest in oil in place, consisting of his undivided interest in the lease less the right of recoupment, which is comparable to an oil payment right, carved out of his fractional working interest.

The questions presented by the supposititious case stated herein are answered generally by the above discussion. Specifically, A, the fee owner, realized $100,000 bonus income when the lease was executed. He also realizes as income one-sixteenth of the proceeds from production until that fraction produces $100,000, and one-eight of such production as royalty income so long as production continues. All of such income is ordinary income. He is entitled to corresponding depletion allowances, and suffers reductions in the bases of his oil payment and royalty interests resulting from such depletion deductions. A lessee who subleased or assigned his interest for like consideration would occupy a comparable position. *The $200,000 which C paid to B was consideration for the sale of B's inter-*

est, less the retained oil payment of one-sixteenth interest until $100,000 is produced. B is not entitled to depletion on the $200,000 cash payment, but he is entitled to depletion on such retained interest. By the "carried interest" arrangement between C and D, the former converts a depletable economic interest in oil in place into a nondepletable contractual right to share in D's net income after recoupment by D of all development costs and expenses. *Had C received a cash payment, it would have represented proceeds realized upon the sale of a capital asset by him.* E, irrespective of words purporting to convey ownership of oil in place, acquired a depletable economic interest to the extent of his oil payment right for a capital investment measured by the expenditure made by him in drilling and equipping the well. *F acquired a like interest for the $15,000 furnished by him to D for development purposes. His interest would have been the same had D not been pledged to expend the $15,000 for development. In that event, however, the transaction would not have been only an investment of the stated sum by F but a sale of an oil payment interest by D, and the latter would have been required to allocate thereto a part of his basis and compute gain or loss.* D, of course, acquired an economic interest consisting of the seven-eights working interest, less the oil payment rights agreed upon by him or his predecessors and held by A, B, E and F. His invested capital account does not include the investment sums contributed by E or F under their contracts with him, but it does include the amount "advanced" by him for

C's share of capitalized development cost. (Emphasis supplied).

J. P. Wenchel,
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Bureau of Internal Revenue.

I.T. 3693

C.B. 1944, p. 272

Internal Revenue Code

The interest of a lessee in oil and gas constitutes an interest in "real property" for Federal income tax purposes. Certain leasehold interests sold by the M Company constitute "real property used in the trade or business of the taxpayer" within the meaning of section 117(a)(1) of the Internal Revenue Code, as amended by section 151 (a) of the Revenue Act of 1942, and are, therefore, excluded from the term "capital assets" as defined therein. However, if such leasehold interests were held for more than six months, they qualify as "property used in the trade or business," as defined in section 117(j) of the Code, as added by section 151(b) of the Revenue Act of 1942, and are subject to the treatment provided for in that section.

Advice is requested whether the interest of a lessee in oil and gas constitutes an interest in "real property" for Federal income tax purposes, and, if so, whether certain oil and gas leases sold by the M Company constitute "real property used in the trade or business of the taxpayer" within the meaning of section 117(a)(1) of the Internal Revenue Code, as amended by section 151(a) of the Revenue Act of 1942, and are, therefore, excluded from the term "capital assets" as defined therein. Advice is also requested whether, if such leases were held for more than six months, they qualify as "property used in the trade or business," as defined in section 117(j) of the Code, as added by section 151(b) of the Revenue Act of 1942, and are subject to the treatment provided for in that section.

Prior to the amendment of section 117 of the Code by section 151 of the Revenue Act of 1942, leasehold interests, whether realty or personalty under State law, were within the capital asset classification. Machinery and equipment and other depreciable property were, however, specifically excluded from this classification. In the amendments made to section 117 of the Code by the Revenue Act of 1942, Congress considered it "more appropriate to treat all property used in the trade or business alike, and not to distinguish between land and other property used in the trade or business." (See Finance Committee Report, C.B. 1942-2, 594.) Accordingly, "real property used in the trade or business" is no longer included in the

definition of a "capital asset," but (except in the case where such property is held primarily for sale to customers in the ordinary course of business) such property may be grouped with certain other assets with the result that "net gains" from all dealings therein are taxable as long-term capital gains, and "net losses" from such dealings may be treated as ordinary losses. This result applies upon a sale, exchange, or involuntary conversion, and the assets included within the group are limited to: (a) Those assets held more than six months used in the trade or business of the taxpayer which are either "real property" or property of a "character subject to the allowance for depreciation," and (b) capital assets held more than six months when the gain or loss results from an involuntary conversion. (See section 29.117-7 of Regulations 111.)

The Federal revenue laws are not to be deemed subject to State law unless the express language or necessary implication of the section involved so requires. (See *Burnet* v. *Harmel*, 287 U.S., 103, Ct. D. 611, C.B. XI-2, 210 (1932); *Helvering* v. *Stuart et al.*, 317 U.S. 154, Ct. D. 1566, C.B. 1942-2, 198.) *The Supreme Court of the United States has held that, for Federal income tax purposes, persons sharing in the depletion allowance with respect to oil leases are characterized as owners of economic interests in oil or mineral in place, regardless of the technical provisions of the instrument creating the lessee's interest.* (See *Palmer* v. *Bender*, 287 U.S., 551, Ct. D. 641, C.B. XII-1, 235 (1933) and *Thomas* v. *Perkins et al.*,

301 U.S. 655, Ct. D. 1237, C.B. 1937-1, 162.) *Accordingly, for Federal income tax purposes, it is held that the interest of a lessee in oil and gas constitutes an interest in "real property."* With respect to the instant lease hold interests, they are held to constitute "real property used in the trade or business of the taxpayer," within the meaning of section 117(a)(1) of the Code, and they are, therefore, excluded from the term "capital assets" as defined therein. However, if such interests were held for more than six months, except with respect to a dealer therein, they will qualify as "property used in the trade or business," as defined by section 117(j) of the Code, and they are subject to the treatment provided by that section.

The specific questions presented and the answers thereto, assuming the M Company is not merely a dealer in leases, are as follows:

1. Are oil and gas leases held by the M Company real property used in the trade or business and so excluded from the definition of capital assets in section 117(a) of the Internal Revenue Code regardless of State law?

Yes, as explained above. The characterization of oil and gas leases (as "real property" or otherwise) under the laws of the various States is immaterial.

2. If oil and gas leases are real property used in the trade or business and are, therefore, excluded from the definition of capital assets, are they subject to the provisions of section 117(j) of the Code?

Sales of oil and gas leases are subject to the provisions of section 117(j) of the Code, if such leases are held for more than six months.

3. If an oil and gas lease is subject to the provisions of section 117(j) of the Code and the gains upon sales or exchanges of property covered by section 117(j) of the Code exceed the losses, is it possible to have an installment sale of an oil and gas lease so that the seller may have the benefit of the installment sale provisions of section 44 of the Code?

Gains from the sale of oil and gas leases which are treated as capital gains under section 117(j) of the Code may be reported on the installment basis under section 44 of the Code, if they otherwise meet the requirements of that section and the regulations promulgated thereunder. (See section 29.117-7 of Regulations 111. See also in this connection, however, G.C.M. 21714, C.B. 1939-2, 218, and *Golden v. Commissioner*, 47 B.T.A., 94.)

4. Is there any distinction to be made between leases that produce oil and gas and those that

are acquired and held for a time and sold without being drilled?

If the leases were acquired with the intention of producing oil or gas and were sold before production, they would be treated the same as producing leases. If, however, a taxpayer is a dealer in leases which are held primarily for sale to customers in the ordinary course of his trade or business, they are excluded from the term "capital assets" under section 117(a) of the Code. (See *Greene et ux* v. *Commissioner*, 141 Fed. (2d) 645.)

5. Are leases held by the M Company in Texas, Kansas, and Louisiana subject to the same rules? If different rules are applicable, please give the rules for each of these States.

The rules set forth herein are applicable for Federal income tax purposes, as explained above, irrespective of the characterization of such leases under the laws of the various States. (Emphasis supplied).

G.C.M. 24849

C.B. 1946-1 p. 66

Internal Revenue Code

Consideration received for the assignment of a short-lived in-oil payment right carved

out of any type of depletable interest in oil and gas in place is ordinary income subject to the depletion allowance where such consideration is not pledged for use in further development.

An opinion is requested with respect to the status, for Federal income tax purposes, of cash payments to owners of depletable economic interests in oil and gas in place as consideration for assignments of in-oil payment rights carved out of the economic interests held by them. Such rights entitle the assignee to oil or gas produced, or the proceeds derived from an agreed share of production if, as and when produced, until a fixed or determinable amount of oil or gas, or an ascertainable sum of money, has been received. *Such rights ordinarily pay out and expire within one or two years.*

G.C.M. 22730 (C.B. 1941-1, 214) deals with the issue only to the extent of distinguishing the case in which an operator assigns an in-oil payment right in return for cash which he is pledged to use in the development of the property (in which event such cash payment is not income to the assignor and its use for the pledged purpose is not regarded as an expenditure by the assignor) from the instant case which involves an outright purchase of an in-oil payment right for cash "wherein there is no such pledge to invest the proceeds in development and the buyer's capital investment would replace the lessee's capital investment

allocable to the interest sold." This statement, made parenthetically in G.C.M. 22730, supra, at page 222, was not enlarged upon there. Consideration must now be given to the Federal income tax effect, in the case of the assignor, of a transaction wherein he receives unqualifiedly a cash payment for an in-oil payment right. Is such cash payment ordinary income or proceeds from the sale of a capital asset? If it is the latter, the capital gain is measured by the cash payment less the allocable part of the basis of the assignor-operator in the oil and gas in place, plus the estimated cost to him of producing the oil involved in the oil payment right—an obligation he assumes without further cost to the assignee.

G.C.M. 22730, supra, recognizes that the holder of an in-oil payment right, however acquired, has a depletable economic interest in the oil and gas in place, which is potentially a capital asset in his hands, provided the conditions of that classification under section 117 of the Internal Revenue Code are met. Such conclusions as to the status of the in-oil payment right in the hands of the grantee are not determinative of the nature of the transaction in the case of the grantor. As pointed out in the cited opinion, the controlling decisions hold that a landowner who grants a lease, or a lessee who subleases or assigns his lease, in consideration of a cash bonus payment and an agreement to pay stipulated royalties is taxable on all such payments as ordinary income. In such a case, the cash bonus payment is regarded as an advance royalty pay-

ment subject to the depletion allowance as respects the lessor or sublessor, though it represents a capital investment by the lessee or sublessee in oil and gas in place, returnable tax-free to him by way of depletion deductions spread over the productive life of the lease asset in his hands. That conclusion rests on the analogy between the receipt of such advance royalty payments and substantial cash payments received by the lessor upon the execution of an ordinary lease, which payments are regarded as advance rental payments taxable as ordinary income. Thus, in connection with the instant issue, as in the cited opinion, the fact that the assignee acquires an asset which potentially qualifies as a capital asset in his hands does not require the conclusion that the assignor parted with such an asset.

In-oil payment rights, royalty rights, and operating rights are analogous in that they are essentially rights to production income characterized as ordinary income when realized. All are regarded as depletable economic interests in oil and gas in place entitling the owner to tax-free return of his investment through the depletion allowance. In-oil payment rights are distinguishable from royalty interests and operating rights in that the latter interests, by definition, extend to the entire oil and gas resource content of the land and, as such, represent forms of fractional property rights into which the property interests in oil and gas in place are commonly divided, whereas an in-oil payment right is a right to income for a lim-

ited time or amount. This difference is emphasized by the fact that an in-oil payment right may be carved out of either of the specified property interests in oil and gas in place, but the reverse is not true. Thus, sales of royalty rights or operating rights are sales of property rights, whereas assignments of in-oil payment rights carved out of such property rights, are, with respect to the assignor, essentially mere assignments of expected income from such property rights for a fixed or determinable period of time.

The issue presented by such assignments of expected income between strangers in interest, presumptively at their present worth, should not be confused with the question presented in such cases as Lucas v. Earl (281 U.S. 111), Helvering v. Horst (311 U.S. 112, Ct. D. 1472, C.B. 1940-2, 206) and Helvering v. Eubank (311 U.S. 122, Ct. D. 1473, C.B. 1940-2, 209), involving donative assignments of income by the earner thereof in an attempt to divide his income between himself and members of his family. There the earner-assignor's attempt is to avoid realization of expected income. Here the assignor expedites such realization. See *Herman M. Rhodes* v. *Commissioner* (43 B.T.A., 780, affirmed, 131 Fed. (2d), 50), wherein the United States Board of Tax Appeals (now The Tax Court of the United States) held that a stockholder's "exercise of his power to sell or assign his right to receive the declared dividend constituted a realization of income by petitioner (stockholder) taxable to him as ordinary income."

In principle the assignment of a right to a dividend seems indistinguishable from assignments of other rights to expected income. Assignments of income rights by the earner for cash or property, measured by the then worth of such rights, may not be disregarded, and as respects such earner-assignor, he has elected to anticipate normal realization by assigning or discounting such right. Consideration received by him represents ordinary income realized by him upon the anticipatory assignment of his right to income. Once such rights to income from property or for services are separated from the earner by his act of assignment, they become property rights owned by the purchaser or assignee with a basis in his hands measured by the consideration paid. Thus, any discounting of the face value of the income right or claim by the earner thereof upon the assignment will result in income to the assignee when such discount is realized by him.

The stated general rule with respect to anticipatory assignments of income for cash or property seems equally applicable to assignments of income arising from royalty or operating property rights in oil and gas in place. As noted above, the characterization of a transaction as a purchase in the case of the assignee is not inconsistent with treating it as a mere anticipatory realization of ordinary income to the earner. That is true under the general rule pertaining to such assignments as well as to cases of grants of depletable interests in oil and gas in place for advance

royalty payments made to obtain such grants under oil and gas leases. Similarly, it is immaterial that the assignment of income vests a depletable right in the assignee. The right to depletion, as such, is not transferred. The assignor, on receipt of the anticipated income thereby realized, is entitled to the depletion allowance which is designed to compensate him for the diminution of his interests sustained by the conversion of capital into ordinary income thereby affected. Thus, qualification of the assigned right as a depletable right in the hands of the assignee springs from the character of the right rather than from the transfer. To the extent that there is a shift of depletable interest, it is analogous to the corresponding shift resulting from a cash bonus or an advance royalty payment made to obtain an oil and gas lease. In both instances, the assignor or grantor is entitled to a depletion allowance which attends the income thereby realized by him, and the assignee, in both instances, acquires a depletable economic interest in oil and gas in place.

For the reasons stated, it is the opinion of this office that consideration (not pledged for development) received for the assignment of a short-lived in-oil payment right carved out of any type of depletable interest in oil and gas in place (including a larger in-oil payment right) is ordinary income subject to the depletion allowance in the assignor's hands. No opinion is expressed with respect to the status of in-oil payment rights extending over a substantial portion of

the life of the depletable economic interests from which such rights are carved. (Emphasis supplied).

J. P. Wenchel,
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Bureau of Internal Revenue.

I.T. 3895

C.B. 1948-1, p. 39

Internal Revenue Code

Application of G.C.M. 24849 (C.B. 1946-1, 66).

G.C.M. 24849 (C.B. 1946-1, 66) holds (syllabus) that consideration received for the assignment of a short-lived in-oil payment right carved out of any type of depletable interest in oil and gas in place is ordinary income subject to the depletion allowance where such consideration is not pledged for use in further development.

Pursuant to authority contained in section 3791(b) of the Internal Revenue Code, G.C.M. 24849, supra, will be applied only to such assignments made on or after April 1, 1946.

Geo. J. Shoeneman,
Commissioner of Internal Revenue.

Approved February 24, 1948.
A.L.M. Wiggins,
Acting Secretary of the Treasury.

I.T. 4003, C.B. 1950-1, p. 10

INTERNAL REVENUE CODE

Assignments of in-oil payment rights

Advice has been requested with respect to the phrase "short-lived in-oil payment rights," as used in G.C.M. 24849 (C.B. 1946-1, 66) and I.T. 3935 (C.B. 1949-1, 39).

G.C.M. 24849, supra, expresses the opinion that consideration received for the assignment of a short-lived in-oil payment right carved out of any type of depletable interest in oil and gas in place is ordinary income to the assignor unless such consideration is pledged for use in further development. As a precaution, pending further consideration of the feasibility of distinguishing between short-lived and long-lived in-oil payment rights, the statement was made in G.C.M. 24849 that: "No opinion is expressed with respect to the status of in-oil payment rights extending over a substantial portion of the life of the depletable economic interests from which such rights are carved."

After careful study and considerable experience with the application of G.C.M. 24849, supra, it is now concluded that there is no legal or practical basis for distinguishing between short-lived and long-lived in-oil payment rights. It is, therefore, the present position of the Bureau that the assignment of any in-oil payment right (not pledged for development), which extends over a period less than the life of the depletable property interest from which it is carved, is essentially the assignment of expected income, from such property interest. Therefore, the assignment for a consideration of any such in-oil payment right results in the receipt of ordinary income by the assignor which is taxable to him when received or accrued, depending upon the method of accounting employed by him. Where the assignment of the in-oil payment right is donative, the transaction is considered as an assignment of future income which is taxable to the donor at such time as the income from the assigned payment right arises.

Notwithstanding the foregoing, G.C.M. 24849, supra, and I.T. 3935, supra, do not apply where the assigned in-oil payment right constitutes the entire depletable interest of the assignor in the property or a fraction extending over the entire life of the property. (Emphasis supplied).

I.T. 4093

C.B. 1952-2, p. 130

Internal Revenue Code

An exchange of a producing oil lease extending until the exhaustion of the deposit, which lease is held for productive use in trade or business or for investment, for the fee interest in an improved ranch to be held for productive use in trade or business or for investment constitutes an exchange of property for property of a like kind under section 112 (b)(1) of the Internal Revenue Code to the extent of the ranch land and permanent improvements thereon, but not including that part of the ranch property consisting of the personal residence, equipment, and livestock.

Advice is requested whether the exchange of a producing oil lease extending until the exhaustion of the deposit for the fee interest in an improved ranch qualifies as an exchange with respect to which no gain or loss is recognized under section 112(b)(1) of the Internal Revenue Code.

Section 112(b)(1) of the Internal Revenue Code provides in part as follows

(1) Property held for productive use or investment.—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale * * *) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

Section 29.112(b)(1)-1 of Regulations 111 provides in part as follows

Sec. 29.112(b)(1)-1. Property held for Productive Use in Trade or Business or for Investment.—As used in section 112(b)(1), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class. * * *

No gain or loss is recognized if * * * a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate * * *.

Section 112(b)(1) of the Code does not apply to property held for trading purposes or for personal use.

It is the position of the Bureau that the interest of a lessee in a producing oil lease extending until the exhaustion of the deposit constitutes an interest in real property for Federal income tax purposes. (See I.T. 3693, C.B. 1944, 272, and Palmer v. Bender, 287 U.S. 551, Ct. D. 641, C.B. XII-1, 235 (1933).)

In *Kate J. Crichton* v. *Commissioner* (42 B.T.A. 490, acquiescence, C.B. 1952-1, 2, affirmed, 122 Fed. (2d) 181), it is held that under article 112(b)(1)-1 of Regulations 94, which article is substantially the same as section 29.112(b)(1)-1 of Regulations 111, an exchange of oil, gas, and mineral rights for an undivided one-half of the fee in a parcel of improved realty was an exchange of properties of a like kind under section 112(b)(1) of the Revenue Act of 1936 (identical to section 112(b)(1) of the Internal Revenue Code.) *The United States Circuit Court of Appeals concluded that under the regulations and the interpretation therein, "the distinction intended and made by the statute is the broad one between classes and characters of properties, for instance, between real and personal property," and that "it was not intended to draw any distinction between parcels of real property however dissimilar they may be in location, in attributes and in capacities for profitable use."*

In the Crichton case, the United States Board of Tax Appeals (now The Tax Court of the United States) distinguished its decision in *Midfield Oil Co.* v. *Commissioner* (39 B.T.A. 1154, acquiescence, C. B. 1939-2, 25), in which it held that an exchange of an oil payment right for an overriding oil and gas royalty reserved from the same lease was not an exchange of property of like kind. The Board pointed out that an oil payment was a limited interest in the property, whereas an overriding royalty was to continue so long as oil or gas might be produced. In other words, an oil payment is a limited interest that is not attributable to the entire natural resource in the property as in the case of an overriding royalty. Therefore, the decision in the Crichton case is not regarded as affecting the conclusions reached in the Midfield Oil case.

In view of the foregoing, it is held that an exchange of a producing oil lease extending until the exhaustion of the deposit, which lease is held for productive use in trade or business or for investment, for the fee interest in an improved ranch to be held for productive use in trade or business or for investment constitutes an exchange of property for property of a like kind under section 112(b)(1) of the Internal Revenue Code to the extent of the ranch land and permanent improvements thereon, but not including that part of the ranch property consisting of the personal residence, equipment, and livestock. (Emphasis supplied).

Rev. Rul. 55-749

1955 C.B.-2, p. 295

Where under applicable state law, water rights are considered real property rights, the exchange of perpetual water rights for a fee interest in land constitutes a nontaxable exchange of property of like kind within the meaning of section 1031(a) of the Internal Revenue Code of 1954, provided the requirements of that section as to holding for productive use in the trade or business or for investment are met.

Advice has been requested whether the exchange of perpetual water rights for a fee interest in land under the circumstances set forth below constitutes a nontaxable exchange of property of like kind within the purview of section 1031(a) of the Internal Revenue Code of 1954.

"A" is the owner in fee of 20 acres of arid land, all of which is in an irrigation district, but he is not entitled to receive water from such district facilities. "B" has a contract with the irrigation district whereby he has the right to "petition into" such district a specified number of acres of arid land for perpetual irrigation purposes. "B" has agreed to petition the 20 acres of arid land owned by "A" into the irrigation district for water facilities in perpetuity in exchange

for one half of such land. *Under the applicable laws of the state in which the property is located, water rights are considered real property rights.*

Section 1031(a) of the Code, regarding the non-recognition of gain or loss from exchanges solely in kind, states, in part, as follows

> "* * * No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment."

Section 39.112(b)(1)-1 of Regulations 118, applicable to section 1031(a) by virtue of Treasury Decision 6091, C.B. 1954-2, 47, provides, in part, that the words "like kind," as used in section 1031(a) of the Code, have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class.

In the instant case, the fact that the two varieties of property, namely water rights and land, may be legally classified as real property does not of itself signify that the two are property of like nature or

character within the meaning of section 1031(a) of the Code. If there be substantial difference in the rights created in and to the respective properties, then the properties are not of like kind. See *Wm. Fleming and Bessie M. Fleming et al.*, v. *Commissioner*, 24 T.C. No. 93.[1]

In the Wm. Fleming and Bessie M. Fleming case, *supra*, the Internal Revenue Service was sustained in the view that an exchange of the fee simple title to a ranch for an in-oil payment right was not an exchange solely in kind under section 112(b)(1) of the 1939 Code. In arriving at its decision, the court stated that in comparing properties to determine their likeness within the meaning of section 112(b)(1) there must be considered not alone the nature and character of the physical properties but also the nature and character of the title conveyed or the rights of the parties therein; that from the applicable regulations the implication is clear that the rights vested in the respective grantees in and to the properties exchanged must be of the same general character or of substantial equality and, if they are not, then the properties exchanged are not of like kind within the meaning of the Code. Under the circumstances in the instant case, where the water right, whatever its size, is in perpetuity, as distinguished from a right to a specific total amount of water or to a specific amount of water for a limited period, the water rights and the land involved are regarded as sufficiently similar to con-

[1]This is the case under consideration.

stitute property of like kind within the meaning of section 1031(a) of the Code. See I.T. 4093, C.B. 1952-2, 130.

Accordingly, it is held that where, under applicable state law, water rights are considered real property rights, the exchange of perpetual water rights for a fee interest in land constitutes a nontaxable exchange of property of like kind within the meaning of section 1031(a) of the Internal Revenue Code of 1954, provided the requirements of that section as to holding for productive use in the trade or business or for investment are met. (Emphasis supplied).

APPENDIX C

Summary of Pertinent Opinions of United States Courts of Appeal

The following summary of opinions of United States Courts of Appeal is perhaps not complete, but is intended to present in chronological order at least the more pertinent of such opinions.

Alexander v. King, 46 F 2d 235 (CCA 10-1931) Certiorari denied 283 US 845

Proceeds received from sale of oil received as royalties held taxable as income and not as capital gain from sale of capital assets.

Darby-Lynde Company v. Commissioner, 51 F 2d 32 (CCA 10-1931)

"A taxpayer is not entitled, as a matter of right, to make any deductions from income for depletion on account of oil extracted and sold during a taxable year. Stanton v. Baltic Mining Co., 240 US 103, Burnet v. Thompson O & G Co., 283 US 301; United States v. Biwabik Min. Co., 247 US 116; Stratton's Independence v. Howbert, 231 US 399. Authority for such deduction must be found in the applicable statutes. Burnet v. Thompson O & G Co., supra."

Anderson v. Commissioner of Internal Revenue, 81 F 2d 457 (CCA 10-1936)

The outright sale of mineral interests, as distinguished from a lease with royalty reserved, should be treated as a sale of capital assets for purposes of taxation. In this case the Commissioner confessed error as to his attempt to hold otherwise.

Fleming v. Commissioner, 82 F 2d 324 (CCA 5th-1936)

This case involved the sale of oil and gas leases for cash with a reserved oil payment in favor of the seller. The Court said:

> "It is asserted generally that all persons who have an 'economic interest' in the oil and gas in the ground have a right to share in the depletion allowance. Palmer v. Bender, 287 US 551; Helvering v. Twin Bell Oil Syndicate, 293 US 312. But a lessee's interest is everywhere regarded as vendible real property, and the lessee may sell his lease or an interest in it and may thus realize income in the way of a profit on the sale. Such income is not subject to be reduced by the percentage depletion allowance, which applies only to income arising from the operation of the well. Darby-Lynde Co v. Alexander, 51 F 2d 56.

* * * While the contract was phrased as though the lease and all the oil were sold, and as though the proceeds were to be paid back to the seller, the real essence of the transaction was that the lease was sold and all the oil *except* that whose proceeds were to come to the selling taxpayer. The conveyances executed when the cash was paid might very appropriately have *reserved or excepted* sufficient oil from one-half of that thereafter run to pay the agreed sum. It is true that no royalty to continue indefinitely was reserved, and that the reservation was limited not to so many barrels nor to such a length of time, but to so much oil as would sell for the agreed sum. But it was in effect an exception or reservation of oil. The thing sold for the cash consideration was the lease and all the oil except that so reserved."

Commissioner v. *Williams*, 82 F 2d 328 (CCA 5th-1936)

The holder of an oil payment reserved in an assignment of oil and gas leases is entitled to depletion with respect to his receipts applicable to the satisfaction of the oil payment.

Ortiz Oil Co. v. *Commissioner*, 102 F 2d 508 (CCA 5th-1939) - affirming 37 BTA 656 - certiorari denied 308 US 566.

In this case taxpayer corporation carved out oil payments from oil and gas leases and disposed of them for cash. Its position before the Board of Tax Appeals was that all of the income applicable to the oil payments constituted its income, as to which a depletion allowance was applicable, and that the difference between the amount received for the oil payments and the amount which they yielded to the oil payment holder was deductible over the pay-out period as interest paid by the taxpayer corporation. The Board of Tax Appeals denied this contention, holding that the transaction effected a sale of an interest in the properties against which no depletion, but only an allocable portion of costs, could be deducted, and that the depletion allowance went with the oil payments to their purchaser.

This holding was fully affirmed by the Circuit Court for the Fifth Circuit and certiorari was denied. In the Circuit Court's opinion it was stated:

> "The Board of Tax Appeals held that the transaction was not a loan and that it constituted a sale of oil in place and that, therefore, the petitioner realized a taxable gain on the transaction in the amount of $154,000 less the amount of the cost bases allocable to the oils required to discharge the oil payments. The Board further held that the petitioner was not entitled to deduct as interest, or otherwise, any part of the proceeds of oil paid to Westbrook and Thompson.

The Board's determination was correct. The money furnished by Westbrook and Thompson was not a loan. It was the cash consideration for a conveyance of stipulated proportions of oil production to the extent in value of $359,333.34 if, as, and when the oil was produced. The portions of production specified belonged to and constituted property of Westbrook and Thompson and the petitioner was only obligated to pay over and account to them when and if the oil was produced. * * *.

Westbrook and Thompson were entitled under the contract to receive specified proportions of the proceeds of oil sales or to take their actual share of the oil production. They simply acquired an interest in oil in place. The right to share in the oil produced constituted an economic interest in the properties to the extent of the amount agreed upon. Palmer v. Bender, 287 US 551.

The Board also properly held that the petitioner was not entitled to allowance for depletion on the proceeds of the sale to Westbrook and Thompson. This amount could not properly be included in the petitioner's gross income for the purpose of calculating and determining the percentage depletion allowance given by section 114(b)(3) Revenue Act of 1932. * * *

The extent of the proportion of proceeds from sales of oil received by Westbrook and Thompson constituted income to them, and the balance only constituted the gross income of the petitioner. * * * The petitioner was entitled to a depletion allowance deduction computed only on the income received by it as its portion of the oil produced in the tax year. 'The owner of an interest in the deposit is entitled to deduct for depletion of the part producing his income but may not deduct for depletion of a share belonging to another'. Thomas v. Perkins, 301 US 663 * * *."

Thomas v. *Peckham Oil Company*, 115 F 2d 685 (CCA 5th 1940)

Upon the sale of producing oil and gas leases and related equipment, with the reservation of oil payment interests, the entire basis for the equipment (personal property) and an aliquot portion of the basis of the oil reserves is deductible from the consideration.

Columbia Oil & Gas Co. v. *Commissioner*, 118 F 2d 459 (CCA 5th - 1941)

This case is very similar to the Peckham Oil Company case supra. The Court said

"It is clear that Columbia retained a portion of its holdings and that the allocated cost of the retained portion may be recovered by depletion al-

lowances. Palmer v. Bender, 287 US 551; Thomas v. Perkins, 301 US 655."

Cullen v. *Commissioner*, 118 F 2d 651 (CCA 5th - 1941)

A group of oil properties were assigned—in some cases with reservation of oil payment interests and in others with reservation of unlimited overriding royalties. The Court held that depletion was allowable upon the cash consideration, and all other amounts received where unlimited overriding royalties were reserved, but that percentage depletion should not be allowed with respect to the cash consideration received where only oil payment interests were reserved.

Pettit v. *Commissioner*, 118 F 2d 816 (CCA 5th 1941)

Pettit owned various oil payment interests. He contended that he was entitled to treat the proceeds which he received from day to day sales as produced of the oil applicable to these oil payments as capital gain. The Board of Tax Appeals and the Court of Appeals denied this contention. The latter Court said:

"The Commissioner conceded that, by the contracts, petitioners acquired the right to have specified quantities of oil lifted and delivered to them above ground, and that petitioners had an economic interest in the oil which entitled them to

depletion. He conceded too that 'if petitioners had sold their contracts outright, they would have been entitled to the benefit of the capital gains provision."

Commissioner v. *Crichton*, 122 F 2d 181 (CCA 5th - 1941)

This case affirmed the holding of the Board of Tax Appeals (42 BTA 490) that the following exchange gave rise to non-recognition of gain under the Revenue Act of 1936. The transaction was thus described by the Court of Appeals:

> "In 1936, respondent and her three children, owning, in undivided interests, a tract of unimproved country land and an improved city lot, effected an exchange of interests. Her children transferred to respondent their undivided interest in the city lot. Respondent transferred to her children, as of equal value, an undivided 3/12 interest in the 'oil, gas and other minerals, in, on and under, and that may be produced from' the country land."

The Court first held that the applicable statutory provision was so general in terms as to render an interpretative regulation appropriate and that the applicable Treasury Regulation is Article 112(b)(1)-1 Treasury Regulations 94). and said:

"For the regulation and the interpretation under it, leave in no doubt that no gain or loss is realized by one, other than a dealer, from an exchange of real estate for other real estate, and that the distinction intended and made by the statute is the broad one between classes and characters of properties, for instance, between real and personal property. It was not intended to draw any distinction between parcels of real property however dissimilar they may be in location, in attributes and in capacities for profitable use."

Commissioner v. *I. A. O'Shaughnessy, Inc.*, 124 F 2d 33 (CCA 10th - 1941)

The taxpayer corporation had acquired several oil payments, at least some of which were carved out payments. The question was as to the taxpayer's right to depletion with respect to the amounts received from the oil applicable to these oil payments. The Court went extensively into the Supreme Court decisions as to economic interest and the right to a depletion allowance, and said:

"Thus it is made abundantly clear that one who acquires by contract, in whatever form, a right to the production from an oil and gas well, or the proceeds thereof until a stipulated amount has been paid, without any other or further security except the contingency of the production, thereby becomes the owner of an economic inter-

est in oil in place, depletable under Section 23(m), 114(b)(3)."

Lee v. *Commissioner of Internal Revenue*, 126 F 2d 825 (CA 5th) - 1942

This case involved the method of computing the allowance for depletion with respect to several oil payments. The holding in 42 BTA 1217 was affirmed. The Court said:

> "In an opinion fully finding the facts and developing the principles thought to be controlling, as to oil payment contracts petitioners had acquired at different times and under different circumstances, the Board declared: that the interest of petitioner was an interest in the oil in place; 'that they must look to depletion for the recovery of their cost and may not recoup cost out of production before being required to report any of the proceeds as gross income' * * *.
>
> The administrative and judicial view and treatment of oil payments as to cost recovery, has little by little more closely identified them with oil royalties. The resemblances between the two have outweighed the differences and it has been finally determined as to them both; that taxpayers make capital investments in oil and gas in place, alike whether they acquire royalties or oil payments; that the production oil and gas, for the benefit

of royalty and oil payment owners is an income producing operation, not a conversion of capital investment; and that as to each, for the recovery of cost, depletion must be alone looked to. Anderson v. Helvering, 310 US 404; Pettit v. Com'r 118 F 2d 816; Columbia Oil & Gas v. Com'r, 118 F 2d 459; Com'r v. O'Shaughnessy, Inc., 124 F 2d 33.

It being the accepted view now that the receipts of oil payments are the result of an income producing operation, and not of one which merely returns capital, it follows that the theory upon which the Laird case (91 Fed 2d 498) was rested, that the receipts of oil payments were returns, not of income but of capital, has fallen and that the case must be regarded as overruled. The order of the Board was right. It is affirmed."

Commissioner of Internal Revenue v. *Rowan Drilling Company*, 130 F 2d 62 (CA 5) - 1942

This case involved the treatment of carved out oil payments received by a drilling contractor as the consideration for drilling wells. The Court said:

The Board of Tax Appeals agreed with the Commissioner that the costs incurred in the drilling of three wells for oil payments were capital investments rather than ordinary business expenses;

and it agreed with the taxpayer that percentage depletion deductions should have been allowed with respect to its income derived from the oil payments.

We think the conclusions reached by the Board were correct in both instances, and that its order should be affirmed. It is no longer open to doubt that the ownership of oil in place is a capital asset, and that the acquisition price of the asset, whether paid in cash or services, is a capital investment that may not be treated as a business expense for income tax purposes, but must be recouped by depletion deductions from gross income." Citing Palmer v. Bender, 287 US 551; Thomas v. Perkins, 301 US 655; Aenderson v. Helvering, 310 US 401; State Consolidated Oil Co. v. Commissioner, 66 Fed 2d 648; Dearing v. Commissioner, 102 F 2d 91; United States v. Sentinel Oil Co., 109 F 2d 854.

Bankers Mortgage Company v. *Commissioner*.
141 Fed 2d 357 (CA 5th) - 1944

In this case the Court affirmed per curiam the holding of the Tax Court that a transaction by which Bankers Mortgage Company received from an oil company $300,000 and executed therefor two non-negotiable notes due on or before thirty years after date, and at the same time executed a deed of trust purporting to secure payment of these notes by an assignment of

certain oil and gas and sulphur interests, coupled with a contract permitting the taxpayer to absolve itself from liability on the notes by surrendering the properties, was a sale and not a transaction which produced depletable income.

West v. *Commissioner of Internal Revenue*, 150 F 2d 123 (CA 5th) - 1945

This case analyzed a complicated transaction to determine whether there was a sale producing capital gain or a lease producing depletable income with respect to the cash consideration paid, and upheld the Tax Court's holding that the transaction more closely resembled a leasing transaction.

Fleming v. *Campbell*, 205 F 2d 549 (CA 5th) - 1943

This case involved the applicability of *Section 112 (b)(1)* of the Revenue Code of 1939 to an exchange of carved out oil payments for a mineral interest in other lands. The Court held that the properties exchanged were of like kind under the aforesaid statutory provision and that no gain was to be recognized. The Court said:

"In the first place, both interests exchanged were interests in land. In the second place, neither interest was a 'leasehold of a fee' in the sense in which that term is used in the regulation. Both

were interests in minerals in place. Both were therefore interests in land, interests not in personal but in real property, in short, real rights.

Bearing in mind that neither the statute nor the regulation requires that the things exchanged be identical but only that they be 'of a like kind', we think it would be difficult to find interests more like in kind that are these mineral interests. Certainly if, as we held in the Crichton case, an exchange of taxpayer's undivided interest in minerals in unimproved country land for an undivided interest in improved city land, was an exchange solely for property of like kind, the exchange here of mineral interests for mineral interests was not an exchange of property of unlike kind merely because one of the mineral interests was of indefinite, the other of definite duration."

Campbell v. *Prothro*, 209 F 2d 331 (CA 5th) - 1954

The question here was whether the donation of calves relieved the donor of income when the donee disposed of the donated livestock. In distinguishing the case from *Lucas* v. *Earl*, 281 US 311 and *Helvering* v. *Horst*, 311 US 112, and other cases, the Court said:

"Here not interest due on choses in action in the year in which the assignment is made, but calves,

chattels, whose value could be realized only by a sale, were given. We have found no case, we have been referred to none holding that unrealized appreciation in the value of cattle given away would be regarded as ordinary income merely because they had no base, were kept for sale in the ordinary course of business, and when sold by the taxpayer would have been ordinary income."

Caldwell v. *Campbell*, 218 F 2d 567 (CA 5th) - 1955

This case held that Caldwell, who carved out oil payments of considerable duration out of royalty interests and sold them to a charitable Foundation, received gain taxable as long term capital gain as installments were collected. The Court refused to apply the doctrine of Lucas v. Earl, 281 US 111 to the transactions, saying:

"His (the Collector's) argument, that because the royalties out of which the in-oil payments were earned would, when received, be income to the grantor, they cannot be regarded and sold as capital assets, and transfers of them must under the teachings of the Earl case be treated as anticipatory assignments of income will not, we thing, at all do. Such arguments run counter to both the fact and law of the matter, to the fact in that the carving out and the sale or retention

of in-oil payments property to be bought and sold constitute a large part of the dealings in oil in Texas, to the law in that the decisions of State and Federal courts are to the contrary, and that the treatment normally accorded them taxwise is likewise to the contrary.

As we understand appellee's brief, he concedes that this is so where a royalty or part of it is sold, or even where the sale is of an in-oil payment, if this is all that the seller owns."

Commissioner v. *Hawn*, 231 F 2d 340 (CA 5th) - 1956

This is the last case relating to carved out oil payments decided by the United States Court of Appeals for the Fifth Circuit before the cases now under consideration by this Court reached it. Hawn had acquired by donation an oil payment interest in a substantial amount. At the time of the transaction, the unsatisfied portion thereof amounted to more than $850,000. In 1949 he entered into a contract with a building contractor for the construction of a residence for him and, in connection therewith, assigned to the contractor all of his interest in the oil payment until the contractor had received therefrom $120,000, whereupon the contractor's interest was to terminate. As a part of the same transaction the parties agreed:

"As a part of this agreement you agree to furnish me all bills for materials, labor, furnishings, etc., in connection with the above mentioned residence to the extent of $115,000.00.

It is understood and agreed that you are financing the furnishing of the above mentioned items with one of the local banks. You are to reimburse yourself for any interest paid out of the difference between the $120,000.00 oil payment and the amount you are paying for the oil payment, namely, $115,000.00 and any excess of any amount above the $115,000.00 with interest at 5% will be returned to me out of the oil payment.

Should, however, the amount of $115,000.00 plus interest at 5% exceed $120,000.00 I will personally be liable to you for such amount, * * *"

In holding that the transaction did not produce capital gain, the Court ultimately said:

"The effect was the same as though Hawn had borrowed the funds required, using the oil payments as collateral and applied the proceeds of such loans to pay the contractor, and then repaid his loans as the oil payments were received. Here this was accomplished and substantially the same thing was done through the person of the contractor. The government contends that the whole arrangement made the contractor the agent for

Hawn in the building of his house. While we need not cast it in this mold, we do find that the course of dealings did not amount to a sale or exchange of capital assets under section 117."

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In the

Supreme Court of the United States

OCTOBER TERM, 1957

No. 108

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

JOHN WRATHER, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR RESPONDENTS, JOHN WRATHER, et al.

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OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court in the *Wrather* case (R. 211-213) are not officially reported. The opinion of the Court of Appeals (R. 237-238) is reported at *241 F. 2d 69*.

JURISDICTION

The judgment of the Court of Appeals was entered on February 1, 1957. (R. 238-239) The petition for a Writ of Certiorari was filed April 17, 1957, and was granted June 3, 1957. This Court has jurisdiction under *28 U. S. C., Section 1254.*

STATUTES INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939, which are Section 117(a)(1) and Section 117(j), are set forth in the Appendix, *infra*, pp. 17-19.

QUESTIONS PRESENTED

The question involved in this case is whether both Courts below erred in holding that the taxpayer John Wrather's share of the proceeds received from the sale of oil payments by the partnership of which he was a member was long-term capital gain under Section 117 of the Internal Revenue Code of 1939 rather than ordinary income subject to depletion.

STATEMENT

The basic facts were all stipulated (See R. 207-210, 214-236) except that there is some pertinent testimony. (See R. 206-207).

During the year 1948, which is the taxable year here in issue the taxpayer, John Wrather, was a member of a partnership known as the George & Wrather Drilling Com-

pany. (R. 208) The partnership was in the oil business, its principal activity being drilling for and producing oil and gas from properties owned by the partnership. (R. 207) Among other properties, the partnership owned oil and gas leasehold or working interests in two leases known as the Brown Lease on land located in Illinois and the Kieffer "A" Lease on land located in Indiana. The partnership owned an undivided 7/24ths interest in the Brown Lease and an undivided 5/16ths in the Kieffer "A" Lease. (R. 208, 209) Both the Kieffer "A" and Brown Leases were held by the partnership for the development and production of oil, gas and other minerals therefrom. (R. 210) Both leases were productive and had produced income for the partnership prior to 1948. (R. 208, 209)

By a conveyance dated June 19, 1948, the partners and their wives, as individuals and for the partnership, sold and conveyed to the Indiana Farm Bureau Cooperative Association, Inc., hereinafter referred to as the Cooperative, an oil payment in the amount of $130,000.00 to be paid out of 9/10 of 7/24 of 7/8 of the oil produced and saved from the Brown Lease. (R. 208) In consideration for this oil payment assignment the Cooperative paid the partnership $125,000.00 in cash on or about the date of the assignment. (R. 208)

By another conveyance dated June 19, 1948, the partners and their wives, as individuals and for the partnership, sold and conveyed to the Cooperative an oil payment in the amount of $155,000.00, to be paid out of 9/10 of 5/16 of 7/8 of all the oil produced and saved from the Kieffer

"A" Lease. (R. 209) On August 16, 1948, the partners and their wives conveyed to the Cooperative another $12,500.00 oil payment payable out of the same fraction of the Kieffer "A" Lease. (R. 209) In consideration for these oil payments from the Kieffer "A" Lease, the Cooperative paid the partnership $162,500.00 cash on or about the date of the assignments. (R. 209)

In June 1948 the Cooperative received its first proceeds attributable to the oil payments from both leases. By January 1952, the Cooperative had received $130,000.00 from the Brown Lease and by June 1953, $167,500.00 from the Kieffer "A" Lease. (R. 210) The reasonable pay-out time of the three oil payments was calculated at the time of the assignments to be from four to six years. (210)

In their joint income tax returns for 1948, taxpayers reported taxpayer John Wrather's one-half (½) share of the proceeds in the amount of $143,750.00 as long-term capital gain. This controversy arises out of a determination by the Commissioner that the sale proceeds are taxable as ordinary income subject to depletion. (See R. 211)

ARGUMENT

The *Wrather* case is one of five cases all involving the same basic issue. The other cases are *Lake*, *O'Conner*, *Fleming* and *Weed*. The Government has filed a single brief in all five cases but since there are different counsel for each of the taxpayers, a single brief for the taxpayers presented obvious problems too difficult to overcome in the short time allowed. Nevertheless, the principle affirmative arguments of the taxpayers are substantially the same and the

briefs for the taxpayers in the *Lake* and *O'Conner* cases so fully and persuasively submit the arguments for the taxpayers that it is felt that a lengthy repetition thereof in this brief would unduly burden the Court.

Accordingly, this brief will be limited to a summarization or outline of the basic arguments with specific comments on certain matters peculiar to the *Wrather* case.

The position of the taxpayer is that the oil payment sales here in controversy were bona fide sales of a substantial property interest, the gain from which is taxable as long-term capital gain under *Section 117 of the 1939 Internal Revenue Code*.

I.

FEDERAL TAX CHARACTERISTICS OF OIL PAYMENTS

A. Sources of Oil Payments—

Oil Payments are property interests in oil in place in the ground and are not new or novel to the oil industry since they have played a vital part in the development of the industry from the beginning. An oil payment may be created by transferring an interest in an oil and gas property and "reserving" the oil payment, or an oil payment may be "carved-out" from a quantitatively larger interest and transferred to another. In either case, the tax characteristics of the oil payment are the same. The Government's attack in these cases suffers from fundamental error because it ignores the established nature of oil payments for Federal tax purposes.

B. Economic Interest—

An owner of an interest in oil and gas in place (i.e., in the ground) has an "economic interest" in the oil and gas in place entitling him to an allowance for depletion upon proceeds derived from production and sale of the oil.[1] The requisite economic interest is possessed by owners of oil and gas leasehold or working interests, royalties, overriding royalties and *oil payments*. The manner in which the interest is acquired does not affect the presence of an economic interest in the owner.

An economic interest in oil in place exists when the owner must look solely to the oil in place to realize upon his capital investment therein.[2] Congress has provided an allowance for depletion to replace the owners capital investment in the oil in place which is consumed by the gradual extraction and sale of the oil in the day to day producing operations.[3] The assignees in these cases acquired an economic interest in the oil in place and are entitled to the depletion allowance.[4]

---

[1] *Palmer v. Bender, 287 U. S. 551; Thomas v. Perkins, 301 U. S. 655; Anderson v. Helvering, 310 U. S. 404; Burton-Sutton Oil Company v. Commissioner, 328 U. S. 25; Commissioner v. Southwest Exploration Company, 350 U. S. 308.*

[2] *Anderson v. Helvering, 310 U. S. 404.*

[3] *Burnet v. Harmel, 287 U. S. 103.*

[4] The Government urges that the "form" of the conveyances in the *Wrather* case (See Exs. G-7, I-9, and J-10, R. 225-227, 230-236) reduce the interests conveyed to nothing more than a right to receive cash payments. The form used can be misleading until it is realized that Wrathers assignee under the law received a conveyance of an undivided interest in the oil and gas in the ground and acquired all rights of ownership in and to it. This follows from the nature of the conveyance and is not dependent or mere form. Moreover, in *Anderson v. Helvering, supra*, this Court, in discussing the earlier decision in *Thomas v. Perkins, supra*, states: "The decision did not turn upon the particular instrument involved, or upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for [oil] payments of that type."

C. Owner May Produce the Oil or Sell His Interest—

There are two ways by which the owner of oil and gas properties may realize upon his capital investment in the oil and gas in place:

1. The oil may be extracted and sold thereby producing ordinary income subject to depletion; or

2. All or some part of the interest in the oil in place may be sold thereby producing capital gains which are not subject to the allowance for depletion.

D. Oil Payments Are Real Property—

Oil and gas leasehold or working interests, royalties, overriding royalties and "retained" oil payments are everywhere regarded as real property. It does not appear that the Government would contend otherwise. The manner of creation or acquisition does not transmute real property into personal property. An oil payment "carved-out" and assigned out of any of the aforementioned mineral properties of necessity remains of the same character, namely, real property. State and local law regards oil payments as real property in that they are subject to real estate ad valorum taxes, they descend to heirs as realty and they are subject to the Statute of Frauds and to real property recordation requirements.

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[1] *People, ex rel. Carroll v. Bell, 85 N. E. 593, 237 Ill. 332; Transcontinental Oil Company v. Emerson, 131 N. E. 645, 298 Ill. 394, 16 ALR 507; Sheffield v. Hogg, 124 Tex. 290, 77 S. W. 2d 1020; Shepard v. Standlind O & G Company, 125 S. W. 2d 290; Tennant v. Dunn, 130 Tex. 285, 110 S. W. 2d 53.* See also: Summer's "Law of Oil and Gas" (1954), pp. 422, et seq.

II.

BONA FIDE SALES OF OIL PAYMENTS SUBJECT TO CAPITAL GAINS TREATMENT

A. Sale of Real Property Used in Trade or Business—

Clearly the oil payment sales here involved were sales of property and fall under the literal terms of the capital gains provisions of Section 117 of the Internal Revenue Code of 1939.[6] Moreover, these sales are not within the exclusions under Section 117 except that they were sales of "real property used in the trade or business" and thus are excluded from the definition of capital assets under Section 117(a) but they come within and are allowed capital gains treatment under Section 117(j).

B. Mineral Properties Both "Fruit" and "Tree"—

Oil and gas in place represents at one and the same time the owner's capital investment property and is also future income to be realized by extraction and sale of the oil. With this dual personality, it is both the "fruit" and the "tree." Consequently, ordinary concepts of taxability do not apply to oil and gas properties. To argue that what was sold in these cases was future income only, ignores completely the capital investment feature of the taxpayers' property. While the oil in place may represent future income, it must be extracted and sold to produce ordinary depletable income. If the capital investment property itself or a part thereof is sold, as was done here, capital gain results and depletion is not allowable.

[6]See Appendix, *infra*.

C. Relief From Excessive Tax Burdens on Gains Resulting From Conversion of Capital Investments—

It is difficult to conceive of a more striking example of conversion of capital investment property than in the sale of these oil payments. In the instant case the purchasers waited 4 to 6 years before realizing fully on their capital investment. One of the oil payment transfers involved in these cases had a 10 to 12 year pay-out.[7] Realizing the dual nature of these mineral properties as being both capital investment property (or tree) and future income (or fruit), capital gain treatment is even more obviously called for.

It is not believed that Congress intended to cause 12 years of so-called "future income" to be bunched into a simple accounting period to be taxed at excessive surtax rates. On the contrary, Congress intended to relieve this burden by enacting the capital gains provisions. The oil payment sales involved here were isolated transactions and were not in any sense similar to the day to day business operations of an oil producer or of a manufacturing operation.[8]

[7] (See R. 184), *Commissioner v. Wm. Fleming, et al.*

[8] *Burnet v. Harmel, 287 U. S. 103,* and *Corn Products Company v. Commissioner, 350 U. S. 46,* are inapposite here. The granting of an oil and gas lease was involved in the *Harmel* case. The Court decided that the transaction was not a "sale" for tax purposes and, therefore, the capital gains provisions did not apply. In *Corn Products,* the taxpayer engaged in hedging transaction in corn futures. It was found unequivocally that the transactions involved were an integral part of the taxpayer's business designed to protect its manufacturing operations. Such transactions are inherently not capital gains transactions. They are the regular, daily business dealings of the taxpayer and are not the isolated, non-curring conversion of capital assets represented by the sales in this case.

III.

ASSIGNMENT OF INCOME RULE IS INAPPLICABLE

A. Unjustified Extension of Rule—

Taxpayers do not quarrel with the tax results arising out of a proper application of the assignment of income rule. But the Government's attack here requires an unwarranted extension of that rule into virgin territory. The facts in these cases present business transactions which are in no sense donative assignments of income which have for their principal purpose a re-arrangement within a family group of family income and having no real economic consequences other than tax savings.[9] This was not an assignment of derivative income such as future rents or future interest. In fact, except to the extent mentioned in describing the dual nature of mineral properties, oil payments are not income at all.

B. Not Mere Diversion of Income—

The assignment of income rule contemplates that there was no *sale* of property. More accurately it might be said that the application of the rule requires that the sale be ignored and treated as if it were a mere diversion of pure income to another. Of course, there are transactions involving transfer of oil payments which may be so lacking in substance as to be no more than a mere diversion of

[9]Cf., *Helvering v. Horst*, 311 U. S. 112; *Harrison v. Schaffner*, 312 U. S. 579; and *Helvering v. Clifford*, 309 U. S. 331.

income to a third party.[10] The facts in the instant case clearly negative any lack of substance in the sale of these oil payments. It follows then, that the assignment of income rule is not applicable to these cases.

IV.

LEGISLATION—CONGRESSIONAL, ADMINISTRATIVE, JUDICIAL

A. Congressional Legislation—

Congress enacted the original capital gain provisions in 1921, clearly intending that they should apply to the sale of mineral properties.[11] The trend over these 37 years has been to liberalize the coverage of the capital gains provisions. To this end, Congress has gradually reduced the required holding period of a capital asset from two years to six months in order to qualify for long-term capital gain. Section 117(j), under which the instant case falls, was added in 1942 and other liberalizing amendments have been made from time to time.

If there is to be denial of capital gain treatment in cases of oil payment sales such as these, it is plain that Congressional action is required.

B. Administrative Legislation—

From 1921 to 1946, the Treasury Department recognized that sales of carved-out oil payments were subject to the

[10] E. g. Rudco Oil and Gas Company v. U. S., 82 Fed. Supp. 746 (Ct. Cls., 1949) where a corporation assigned an oil payment to it stockholders to satisfy a cash dividend.

[11] See the Report of the Ways and Means Committee, 67th Cong., 1st Sess., H. Rept., 350, in connection with the Revenue Act of 1921.

capital gains provisions.[12] But in 1946 by administrative fiat, the Treasury Department attempted to change the law. It was claimed that the anticipation of income rule applied to sales of carved-out oil payments of short duration; e. g., those which took one to two years to pay-out.[13] This was done without either congressional or judicial sanction. Not satisfied however, in 1950 the Treasury Department adopted the extreme view being urged on this Court in these cases.[14] That is to say, the Government would have this Court hold that the sale for cash of *every* carved-out oil payment, without regard to whether the pay-out is three months or 13 years, produces immediate ordinary income subject to depletion. After extensive review by the lower Courts that proposition has not been accepted by a single judicial body.[15]

At the time the oil payments were sold in the instant case, this taxpayer could not know that these transactions would be attacked as assignments of income. On the contrary, the sales were made in 1948 at a time the Treasury's published position allowed capital gains treatment.[16] The

[12]Many private rulings to this effect were issued. *Cf. R. E., Nail, 27 B. T. A. 33 (1932), Acq. XII-1 C. B. 3; Majestic Oil Corporation, 42 B. T. A. 659 (1940), Acq. 1940-2 C. B. 5; Ortiz Oil Company, 37 B. T. A. 656, Aff'd. (5 Cir., 1939), 102 F. 2d 508, cert. den., 308 U. S. 566.*

[13]G. C. M. 24849, 1946-1 C. B. 66.

[14]I. T. 4003, 1950-1 C. B. 10.

[15]No Court has yet held that the cash consideration for the sale is all taxable in the year of sale as ordinary income, thus "bunching" the income into high surtax brackets.

[16]The duration of the oil payments in the *Wrather* case were 4 to 6 years which was 2 to 3 times longer than those condemned in G. C. M. 24849, 1946-1 C. B. 66.

litigation in this case arises out of a retroactive application of administrative legislation which must not prevail.

C. Judicial Legislation—

In seeking the Supreme Court's endorsement of its position in this case, the Government is asking the Court to usurp the constitutional authority vested in Congress to amend the income tax law. This Court should not do so. The representatives of the Internal Revenue Service are highly successful tax collectors without need for this Court to become Treasury's watch dog. In short, reversal of these cases would be unwarranted judicial legislation.

D. Device Cases—

This does not mean that the Court must stand idly by while taxpayers conceive ingenious methods for avoiding their taxes where these devices lack real substance. But even in the area of carved-out oil payments, the lower Courts have demonstrated an unwillingness to permit "device" cases to succeed.[17] The instant case is not merely an attempt to convert ordinary income into capital gain. In fact, the transaction was in no part a tax avoidance scheme. On the contrary, the sales of these oil payments were bona fide sales of real property used in taxpayer's business.

[17] *Cf., Commissioner v. Hawn (5 Cir., 1956), 231 F. 2d 340.* While the Court in *Commissioner v. Slagter (7 Cir., 1956), 238 F. 2d 901,* appears to accept the Government's extreme contention, it did not in fact do so. The facts in the *Slagter* case show that the purchaser of the oil payments (Ashland Refining Company) was the purchaser of *all* the oil being run from the mineral deposits involved. The Court held, therefore, that the transaction was in the nature of a "loan" and not a sale. It was held that the sellers were taxable on the oil as it was run to the Ashland Refining Company. This is a far cry from what the Government contended there or contends here.

V.

THESE OIL PAYMENTS CONVEYED SUBSTANTIAL PROPERTY INTERESTS

The Government urges alternatively that the oil payments conveyed in these cases are insubstantial, temporary and of short duration. Although, an ample showing has already been made that the transfers were of substantial property interest it will now be shown specifically that the facts in the *Wrather* case refute the Government's contention. The interest owned by the George & Wrather Drilling Company in the Brown Lease was a 7 24ths working interest, and that owned in the Kieffer "A" Lease was a 5/16ths working interest. The oil payments conveyed to the purchaser 9 10ths of the interest owned by the partnership. The 1 10th which was retained was no doubt, only barely sufficient to defray the partnership's share of the lifting costs. It took 4 years in the case of the Brown Lease and 5 years and 3 months in the case of the Kieffer "A" Lease to produce enough oil from the property transferred to satisfy the terms of the conveyance. Whats more it can be shown that the quantity of oil necessary to liquidate the oil payments was approximately 82% of the total estimated oil reserves attributable to the interest owned by the partnership in the Brown Lease and 75% in the case of the Kieffer "A" Lease. This is not the picture of a transfer of property which lacks substantiality. The oil payments conveyed a substantial and durable property interest.

CONCLUSION

The instant case and the other cases involved in this appeal must be decided on their own facts. That is to say, this Court should not strike down the decisions of the lower Courts in the present case in an effort to establish a rule deemed necessary to protect the integrity of the capital gains provisions from a transaction which is no more than a device, is not in substance a sale, or otherwise is lacking in substantiality. The oil payments sold in the *Wrather* case were sales of substantial and durable property interests—they are sales of real property used in the taxpayers' business and should be subject to capital gains treatment.

It is submitted that the decision of the Court below in the *Wrather* case should be affirmed.

Respectfully submitted,

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APPENDIX

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) DEFINITIONS—As used in this chapter—

(1) CAPITAL ASSETS—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or properly held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), or real property used in his trade or business;

(C) a copyright; a literary, musical, or artistic composition; or similar property; held by:

(i) a taxpayer whose personal efforts created such property, or

(ii) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property; or

(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount

basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

* * * * *

(j) Gains and Losses From Involuntary Conversion and From The Sale or Exchange of Certain Property Used in the Trade or Business.—

(1) DEFINITION OF PROPERTY USED IN THE TRADE OR BUSINESS. For the purpose of this subsection, the term, "property used in the trade or business" means property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 23 (l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (b) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in subsection (a) (1) (C). Such term also includes timber or coal with respect to which subsection (k) (1) or (2) is applicable and unharvested crops to which paragraph (3) is applicable. Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such terms does not include poultry.

(2) GENERAL RULE—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnnation of the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsection (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital essets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

(3) SALE OF LAND WITH UNHARVESTED CROP.—In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the

crop and the land are sold or exchanged [for compulsorily or involuntarily converted as described in paragraph (2)] at the same time and to the same person, the crop shall be considered as "property used in the trade or business."

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No. 108

In the Supreme Court of the United States
October Term 1957

Commissioner of Internal Revenue, Petitioner

v.

W. F. Weed, et al

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF FOR RESPONDENT

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In the Supreme Court of the United States
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W. F. Weed, Individual, and Estate of Eleanor M. Weed, Deceased, W. F. Weed, Executor, Respondents

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BRIEF FOR RESPONDENT

OPINION BELOW

The findings of facts and opinion of the Tax Court (R. 252-261) are reported at 24 T. C. 1025. The opinion of the United States Court of Appeals for the Fifth Circuit (R. 262-264) is reported at 241 F. (2d) 69.

JURISDICTION

The United States Supreme Court has jurisdiction under 28 U. S. C. sec. 1254.

The judgment of the Court of Appeals was entered February 1, 1957 (R. 265). Petition for writ of certiorari was granted by this Court June 3, 1957.

STATUTES INVOLVED

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) **General Definition.** — "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) DEFINITION. — As used in this chapter —

(1) (as amended by Sec. 115 (b) of the Revenue Act of 1941, c. 412, 55 Stat. 687, and Sec. 151 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798) property held by the taxpayer (whether or not **Capital assets.** — The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business) but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l) * * * or real property used in the trade or business of the taxpayer.

* * * * *

(4) (as amended by Sec. 150 (a) (1) of the Revenue Act of 1952, **supra) Long-term capital gain.** — The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

* * * * *

(b) (as amended by Sec. 150 (c) of the Revenue Act of 1942, **supra) Percentage Taken Into Account.** — In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

* * * * *

QUESTION PRESENTED

When the Respondent exchanged a sulphur payment for cash and note, should the proceeds of such transaction be taxed to him as capital gains (1939 Code, Sec. 117) or as ordinary income?

STATEMENT OF THE CASE

On December 23, 1947, Weed was the owner of a pooled overriding royalty interest in sulphur produced by the Texas Gulf Sulphur Company from a tract of land referred to as Boling Dome, in Wharton County, Texas. Weed's royalty interest entitled him to receive $.00966133 per long ton of sulphur produced from Boling Dome by the aforementioned company, irrespective of what the market price for such sulphur might be. Royalty payments were made by the company monthly, based on the previous month's production. Weed's $.00966133 per long ton interest represented the aggregate of three pooled royalty interests, each in a lesser amount, received by Weed (a) from his father by two **inter vivos** deeds dated September 1, 1933 and August 15, 1935, respectively, and (b) after his father's death, from the latter's estate by independent executor's deed dated August 1, 1945. Such interest was not held by Weed primarily for sale to customers in the ordinary course of his trade or business. (R. 254-255)

The Boling Dome tract was composed of a number of parcels of land. The owners of the royalty interests in sulphur produced from each of those individual parcels entered into a pooling agreement pursuant to which royalties from sulphur produced anywhere in Boling Dome were to be distributed pro rata among all such royalty interest holders. Thus, Weed's interest is referred to as "pooled." (R. 254)

Weed in 1947 believed that, in 1948 and the succeeding years, he would need all (or a large part) of the credit which was available to him personally at the banks or through similar sources to obtain funds for use in the carrying on of his widespread business enterprises. He, therefore, desired some assurance that

he would have a definite source of funds (other than banks and similar sources) for payment of his individual Federal income taxes due in those later years. (R. 254)

In the summer or early fall of 1947, Weed, Frank C. Taylor (a C. P. A. then retained as accountant for Weed's personal affairs and who prepared Weed's 1947 return), and Marion Munro (a C. P. A. then retained by two of Weed's Corporations and who subsequently prepared Weed's individual joint returns for 1948 and 1949) discussed the problem of Weed's business commitments and the need for providing some sure source of funds with which to pay Weed's individual income taxes, especially those due in January 1948. It was suggested that Weed might sell a portion of his Boling Dome royalty interests, and Munro expressed the opinion that such a transaction would have the advantage of being taxed to Weed at capital gain rates. Munro indicated a probable willingness to purchase a portion of that royalty interest and negotiations followed. (R. 255)

Weed and Munro discussed the amount of money Weed would probably need in later years to pay his taxes, the probable amount of sulphur still in place, (the sulphur deposit was originally estimated to have been 45,000,000 tons of which 24,000,000 tons had been produced) anticipated annual rate of sulphur production, the annual royalty payments which would probably be received by a purchaser of Weed's interest, the probable amount of time required for pay-outs from sulphur production of different sums of money, the discount factor (such as the interest Munro would have to pay on funds borrowed by him to purchase the royalty interest) which affected Munro's profit from the transaction, and the tax savings to Weed. (R. 255)

It was finally agreed that the transaction would be based upon Weed's anticipated requirements for funds

to pay taxes for the succeeding three years, and upon a four-year pay-out period from sulphur production to Munro. On this basis, it was determined that Weed would assign to Munro a portion of his royalty interest on 6,000,000 long tons of sulphur, from which Munro would receive $50,000 within about four years, and that, in return, Munro would pay Weed $13,900 cash and give Weed two notes of $16,300 each, one due in one year and the other in two years. It was necessary for Munro to borrow a portion of the cash required.

Munro's loans from the bank were negotiated by him independently of Weed and not guaranteed by Weed. As security for the loans Munro assigned to the bank the royalty interest purchased from Weed until such time as all his loans were paid. Concurrently with that assignment he notified the Texas Gulf Sulphur Company to make his royalty checks payable jointly to himself and the bank and to mail them directly to the bank. The bank credited the royalty checks received first to the principal and interest due on the above loans and, when that was satisfied, to Munro's personal account. Receipt of royalty checks from Texas Gulf Sulphur Company averaging about $2,000 each from February 28, 1948 until March 20, 1950 (on which date the limited royalty interest on 6,000,000 tons was fully paid out) resulted in its being unnecessary for Munro to borrow more than $11,500 in order to meet the two $16,300 notes due Weed since Munro was able to, in part, pay those notes at maturity with royalties received and accumulated prior thereto. (R. 257).

As above indicated, the limited royalty interest which Weed assigned Munro on December 24, 1947, was paid out within 28 months thereafter. In his income tax returns Munro reported the royalties he received as ordinary income, less cost depletion, in the year of receipt.

Weed used the $13,900 received from Munro on December 24, 1947, in paying the January 15, 1948 installment on his 1947 Federal income tax. (R. 257).

The taxpayer disclosed the transaction fully in his 1947 tax return, treating the proceeds as capital gains and reporting the profits on the installment basis. Taxpayer's 1948 and 1949 returns reported the $16,300 received from Munro for each such year as long term capital gain. The Commissioner determined that the 1948 and 1949 payments were taxable as ordinary income, subject to depletion. The Tax Court held these proceeds were realized from the sale of a sulphur payment and constituted capital gain. This view was affirmed by the Court of Appeals. (R. 258).

SUMMARY OF ARGUMENT

Sec. 117 (a) (4) of the Internal Revenue Code of 1939 defines long term capital as the "gain from the sale or exchange of a capital asset held for more than 6 months—," and Sec. 117 (a) (1) defines "capital assets" as "property held by the taxpayer" with certain exclusions. These definitions were not substantially changed in the 1954 Code.[1]

Thus, the proceeds from the sale of property (held by the taxpayer for more than six months) are entitled to capital gains treatment unless the transaction or the property falls within the exclusions provided by law.

---

[1] Surrey, **Definitional Problems in Capital Gains Taxation.** Federal Tax Policy for Economic Growth and Stability, 404. (Joint Committee on the Economic Report, 84th Congress, 1955.)

Respondent contends a sulphur payment is property and that its sale is not excluded from capital gains treatment; respondent further contends that the Weed-Munro transaction, at issue here, had substance in fact and in law, and being the sale of a capital asset held for six months and not the anticipation of future income was entitled to capital gains treatment.

* * * * *

ARGUMENT

1. A MINERAL PAYMENT IS A SEC. 117 CAPITAL ASSET.

Petitioner's brief concedes, as indeed it must, that a mineral payment is property, the Texas courts have determined that mineral payment rights in Texas are real property interests,[2] but contends that the sale of a "carved-out" mineral payment constituted the assignment

[2] Sheffield v. Hogg, 124 Tex 290, 77 S. W. (2) 1021; Tennant v. Dunn, 130 Tex. 285., 110 S. W. (2) 53. See also A. W. Walker, Jr., Oil Payments, 20 Tex. Law Review pp. 259, et seq. (Jan. 1942). That view has been consistently held by the Texas Courts, appropriate United States Court of Appeals, and the United States Supreme Court which in Thomas v. Perkins, 301 U. S. 655 (1937) determined the nature of an oil payment for income tax purposes and established the rule that an oil payment is an economic interest in the mineral in place even though the payment is to be made in money.

This view expressed by the United States Supreme Court has never been changed and in fact was adopted by the Commissioner of Internal Revenue and urged upon the United States Court of Appeals in Ortiz Oil Co. v. Commissioner, 102 Fed. (2) 508; Cert. denied, 308 U. S. 566.

See also: Lee v. Commissioner, 126 Fed. (2) 825 (1942)
Fleming v. Campbell, 205 Fed. (2) 549 (1953)

of future income. Such a position ignores the essential difference between the property itself and the relationship arising when that property is placed into the channels of commerce.

In the ground mineral deposits are a part of the real estate, minerals produced from these deposits are personal property; but the fact that the deposit may some day be produced and may some day become personal property does not thereby convert such unproduced mineral deposit into the thing it may become.

The distinction between (1) an economic interest in the mineral in place and (2) the right to future income has been employed by this court in **Burnet v. Harmel,** 287 U. S. 103, **Thomas v. Perkins** 301 U. S. 655; **Anderson v. Helvernig,** 310 U. S. 404; and **Burton-Sutton Oil Co. v. Commissioner,** 328 U. S. 25 to point up the difference between a capital asset (on which depletion may be taken) and the proceeds or income therefrom. The fact that minerals may be produced at a future date does not convert their sale (while yet unproduced and in the ground) into the sale of produced minerals; nor does the sale of such economic interest of the minerals in place result in the realization of the future income which may result from the production of the minerals.

When the vendor parts with all of his economic interest in the minerals in place, he sells a capital asset and is entitled to treat the proceeds as capital gains. The vendor of a mineral payment conveys to the purchaser all of his interest in those certain tons or barrels of minerals. Further when the owner of a parcel of land conveys to a purchaser an undivided one-half interest in the North one-half of that parcel, no one has been heard to say that the vendor sells anything less than a capital asset just because he retains all of the

South one-half of the parcel and an undivided half of the North half.

And so it is with "carving-out" a mineral payment — the vendor sells all of his interest in an undivided fraction (as measured by a specific number of tons or barrels) of the mineral in place; he retains no economic interest in the sold minerals, he has no reversion therein, and he has no control thereover, this is the sale of property, not the realization of future income.

The owner of a sulphur royalty has an economic interest in the sulphur in place. It is true that the ordinary sulphur lease provides that the sulphur royalty holder is to be paid a specific sum in dollars or cents for each ton of sulphur produced (rather than a fraction of each barrel of oil in the usual oil lease), but this does not alter the nature of his economic interest in the sulphur in place, and when the owner of the sulphur royalty sells a fraction of that royalty or carves a sulphur payment out of it, he usually describes the conveyed interest as being so many cents per ton of sulphur produced (or so many cents per ton out of so many tons of sulphur produced).

Therefore, when Weed sold Munro a sulphur payment, Weed sold and Munro acquired a depletable property, a fractional interest in certain sulphur in place in the Boling Dome; and Weed reported the proceeds of that sale as capital gains.

2. WEED SOLD MUNRO A CAPITAL ASSET NOT A MERE CLAIM TO FUTURE INCOME

When Munro acquired the sulphur payment from Weed, he took that property subject to all of the risks, rights and benefits of ownership of property of that nature. As the owner of that mineral property, he was entitled to depletion when the minerals were produced. **Thomas**

v. Perkins, supra. Munro owned his interest in that sulphur whether it was produced or not, and he had all of rights which Weed had previously owned in the conveyed sulphur. Munro did not realize income from the sulphur until it was produced; Weed realized his gain from the transaction when he sold the property to Munro (an installment sale under Sec. 44), he had no continuing right or interest in the income realized therefrom by Munro. Had Weed sold Munro a rent house, Munro would have realized ordinary income when he received the rents from the house, but the purchaser's right to the rents does not convert the sale transaction into the realization of future income by the vendor.

In order for the income proceeds from the property to be taxed to the vendor, the transaction must lack substantiality.

3. THE SALE OF THE SULPHUR PAYMENT BY WEED TO MUNRO WAS POSSESSED OF ALL OF THE ELEMENTS OF A BONAFIDE TRANSACTION IN SUBSTANCE AS WELL AS IN FORM.

The Tax Court has already found that the Weed-Munro sale was bona fide (R. 260), and this has been affirmed by the Court of Appeals. Weed had a definite business purpose for selling the sulphur payment; he was the financier of several corporations which were in need of funds and which did not have adequate credit of their own. It was necessary that such funds be furnished, either directly or through endorsement, by taxpayer; and in addition the taxpayer was contemplating entering other businesses and promoting a patent at this time. He did not have sufficient ready cash to pay the federal income tax payment due January 15, 1948 and he decided to provide definite, certain cash for such tax obligations. Actually, the taxpayer did use the proceeds from the sale to Munro to make the tax payment. As a matter

of sound business judgement, taxpayer elected to raise the required cash by sale of this asset — a portion of his sulphur royalty

And the sale of the sulphur payment was actually negotiated in an arm's-length negotiation between Weed and Munro, who secured the funds to pay Weed by an independent bank loan, without aid or endorsement by Weed, and who reported the income from the sulphur payment as ordinary income subject to depletion.

Determination of the nature of the thing sold also adds to the substantialness of the transaction. As a solid in the ground, sulphur ore does not have those qualities which have caused some jurisdictions to apply the doctrine of "capture" to oil and gas operations. Thus, the sale of a sulphur interest may be more comparable to the sale of a coal interest than to the sale of an oil interest.[3]

Contention has been made that the sulphur sale is insubstantial because Weed sold less than all he owned. Weed sold to Munro approximately 86% of his interest in six million tons of sulphur. At the time of the sale Weed's estimates (and on which his dealings with Munro were predicated) showed a remaining sulphur reserve in

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[3] American Law of Property (1952), Part 10, Oil and Gas Rights by Victor H. Kulp, See sections 10.4 and 10.5.

Sec. 117k (2) of the 1939 Internal Revenue Code indicates capital gain treatment of coal sales comparable to the sulphur interest sale here. Certainly statutory provision for coal does not per se include sulphur also but note that GCM 24849 and I. T. 4003, in determining that sales of oil payments may produce ordinary income, use the expression "oil and gas" and omit "and other minerals", so by the same token we may assume that the Commissioner had not intended or had not manifested any intention to treat as ordinary income the proceeds from the sale of sulphur payments.

the Boling Dome field of between eighteen and twenty-one million tons Thus Weed sold 86% of six-twenty-firsts of the estimated remaining reserve, or almost one-fourth of the remaining reserve; this we believe is substantial.

Weed and Munro estimated a four year pay out, yet actually the six million tons were produced in twenty-eight months, and this was due to unusually great production in 1948, which could not have been anticipated by the parties.

A recent and interesting Harvard Law Review note[4] suggests the use of "risks" to determine whether or not a transfer of an oil payment results in ordinary income or capital gain; thus, if a "substantial risk" has been transferred to the buyer, the seller's proceeds are taxed as capital gains.

Here, Munro certainly undertook risk, a decline in Boling Dome sulphur production for any number of reasons would have resulted in loss to Munro. Munro had no guarantee or cushion of interest payments. Weed had no part in Munro's procurement of funds with which to pay Weed, and Munro had no promise from Weed to pay any excess interest charges.

It must recognized that taxpayers may, and have assigned income and employed the form of capital gain transactions without actually and substantially selling a capital asset.[5] Because a wise and proper tax method or

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[4] 69 Harvard Law Review 737, at pages 743, 745 (February 1956) "Distinguishing Ordinary Income From Capital Gain Where Rights to Future Income are Sold."

[5] **Hort v. Commissioner,** 313 U. S. 29
Harrison v. Schaffner, 312 U. S. 579
Corn Products Co. v. Commissioner, 350 U. S. 46 (1955)
Miller, **The "Capital Asset" Concept: A Critique of Capital Gains Taxations,** 59 Yale Law Journal, 837, 1057.

procedure may be improperly employed or subjected to sham transactions does not warrant judicial abolition of the arrangement. Rather, it would appear to be the function of the judiciary to examine those cases of "form over substance" and having determined the bona fides of the transaction, reject the sham. Such has been the practice of the court below which rejected the device employed in **Commissioner v. Hawn,** 231 F (2) 340 as being insubstantial in contrast with its holding in Caldwell v. Campbell, 218 F (2) 340.

Respondent here believes that Court has indicated the proper approach to a solution of the whole problem of the sale of mineral payments when the transaction is an obvious sham, a mere device for diverting income or avoiding tax and lacks the substance of a bona fide sale, the court should set aside the whole transaction and tax the income as it was actually realized.

The solution does not lie in the promulgation of administrative determinations issued after reliance has been had on an accepted method of operation. For many years mineral operations have been financed by the sale of mineral payments, those were generally conceded to result in the realization of capital gains to the seller,[6] when in 1946 G. C. M. 24849 (C. B. 1946-1,66) was issued. It stated that the consideration received for the assignment of short lived (one or two years) oil payment carved out of a depletable interest would constitute ordinary income. It is to be noted that this G. C. M.'s application is limited to **oil and gas** payments (it does not cover the other minerals) which expire within one or two years.

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[6] **Nail v. Commissioner,** 27BTA33

G. C. M. 24849 had been issued, prior to the Weed-Munro transaction, and represented the Internal Revenue position at that time. **After** the Weed-Munro transaction I. T. 4003 (C. B. 1950-1-p-10) was issued. It stated the assignment of carved-out oil and gas payments (not pledged for development, etc.) would result in ordinary income to the assignor. Again this did not include "other minerals".

It is submitted that G. C. M. 24849 and I. T. 4003 do not apply to the Weed-Munro sale of a **sulphur** payment in 1946 which was contemplated to require four years for pay-out.

Respondent submits that the sale of the sulphur payment from Weed to Munro was made for a business purpose and it has been determined by the Tax Court (and sustained by the Court of Appeals) to constitute a bona fide transaction. The combined pay-out period exceeded the definition of short term payments theretofore employed by the Commissioner of Internal Revenue, and the sale of the sulphur payment was the sale of a capital asset and entitled to capital gains treatment, under Sec. 117.

CONCLUSION

It is respectfully submitted that the judgment below should be affirmed

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February, 1958

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No. 108

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1957

COMMISSIONER OF INTERNAL REVENUE, ET AL., Petitioners

vs

P. G. LAKE, INC., ET AL., Respondents

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR REHEARING

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PETITION FOR REHEARING

The respondents in the above styled and numbered cause, acting through their attorneys of record, hereby respectfully petition this Court to rehear this cause and, upon such rehearing, to affirm the decisions of the Court below; or to remand these causes with instructions as hereinafter outlined, or clarify and cor-

rect the holdings of this Court in the respects hereinafter specified. The opinion of this Court was delivered on April 14, 1958.

The errors in this Court's said opinion and holdings are as follows:

A. *As To The Weed Case*

The tax years before the Court were the calendar years 1948 and 1949 (R. 252). The assignment of the sulphur payment involved was made in the year 1947, and the taxpayers reported the transaction as an installment capital gain sale in their 1947 income tax return, in which year they received the installment obligation (R. 256-258). Section 44 (b) of the Internal Revenue Code of 1939, dealing with sales on the installment basis, applies only to sales of real *property* and casual sales of personal property. It should be noted that Section 44 is applicable only to sales of "property", just as Section 117 provides for capital gain treatment on the sale of "property". If, as this Court holds, the sale of a carved out oil (or sulphur) payment is not a sale of "property", but an assignment of future income, then clearly such a sale would not be of "property" within the meaning of Section 44(b) and installment treatment would not be permitted. In such a case Weed, under this Court's decision, would be taxed in full in the year of the sale (1947) which year is not before the Court.

It is inconceivable that this Court intended to hold that "future income" could be sold on the installment basis. If this Court finally so holds, then an attorney who is entitled to collect a large fee in one year could sell his right to that fee on the installment basis and report his gain therefrom over any number of years. If, as this Court apparently held, Weed sold future income, then he made the sale in 1947, and the entire deficiency asserted against him in 1948 and 1949, the only years before the Court, should be expunged; and this Court should so direct.

B. *As To The Fleming-Walsh Exchanges Of Oil Payments For Real Estate*

In reversing the Court below on its holding that no gain or loss was to be recognized from the Fleming-Walsh exchanges, this Court said:

> "As we have seen, these oil payment assignments were merely arrangements for *delayed* cash payment of the purchase price of real estate, plus interest." (Emphasis supplied).

The acquisition of real estate for a "delayed cash payment" cannot produce taxable income. This Court has held (*Palmer v. Bender*, 302 U.S. 63-69):

> "It follows that one does not subject himself to income tax by the mere purchase of property, even if at less than its true value, and that taxable gain does not accrue to him before he sells or otherwise disposes of it."

It necessarily follows that the only income received by the Flemings and Walsh in the years before the Court (1948 and 1949) was the amount produced in those years by the oil payments which they assigned for the lands. These amounts are shown in the Record—pages 146-147, 154, and the income taxable to this group of respondents should be limited to these amounts—less appropriate allowances for depletion—if the Court's holding on the basic question is to be upheld. (See, in this connection, *Commissioner v. Slagter*, 238 F 2d 901, CA 7, 1956).

It is feared that further controversy will result below if this Court does not clearly indicate the application which it intended be given to the above quoted statement. Further, the reversal directed by this Court appears to be a reversal of the judgment of the United States Court of Appeals for the Fifth Circuit, and, if so, this would leave the holding of the Tax Court in the Fleming and Walsh cases intact. The Court's intention in this respect should be clarified.

C. *The Holding of the Court that the Several Transactions Involved Produced Ordinary Depletable Income, and Not Long Term Capital Gain, Was Erroneous For The Following Reasons:*

1. **As To Administrative Practice**

Recognizing that until 1946 the Treasury practice agreed with the contention of the taxpayers in these

cases that the assignment of a carved-out oil payment right was productive of long-term capital gain, the Court then incorrectly stated (footnote 5 of the Court's opinion) that "The pre-1946 (i.e. before the promulgation of G M C 24,849) administrative practice was not reflected in any published ruling or regulation. It, therefore, will not be presumed to have been known to Congress or incorporated into the law by re-enactment." This statement is incorrect because in G C M 22,730, 1941-1, p. 214, published, as the citation indicates, in 1941, it was expressly held that the carving out and sale of an oil payment for cash was a sale, requiring the assignor to compute gain or loss by allocating against the consideration a portion of his basis in the property, if he had not pledged the proceeds to the development of the property. This ruling was reproduced in full in the Lake-Fleming brief, pp. 88-112. The precise holdings referred to are found there at pages 96 and 111.[1] This G C M 22,730 was a carefully considered analysis and restatement of the Treasury's practices and holdings with respect to many types of transactions with respect to oil properties.

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[1] "A cash payment made upon the execution of an instrument stipulating only for oil payments is, therefore, regarded not as an advance royalty payment but as proceeds from a sale in which the payee disposed of his economic interest in oil or mineral in place, less the fraction thereof represented by the oil payment rights reserved by him."

"In that event, however, the transaction would not have been only an investment of the stated sum by F but a sale of an oil payment interest by D, and the latter would have been required to allocate thereto a part of his basis and compute gain or loss."

G C M 24,849, C. B. 1946-1, p. 66, gave notice to Congress that the administrative practice was to treat the carving out and disposition of long-lived oil payments as sales. This ruling was limited to "short lived" oil payments, which "ordinarily pay out and expire within one or two years". This plainly indicated what the previous practice had been as to all carved-out oil payments and that no change was being attempted in the previous treatment of long-lived oil payments. The fact that G. C. M. 24,849 was intended to apply only to short-lived oil payments, as that term is there defined, is reenforced by I. T. 3895, promulgated early in 1938; which again made reference to "short-lived" oil payments. (See Fleming-Walsh brief, page 124.)

That this was the known policy of the Treasury Department is also evidenced by the Treasury's acquiesence in *R. E. Nail*, 27 B T A 33, decided in 1932. There, as to a donative assignment of an oil payment out of a larger interest, the Board of Tax Appeals held that the transaction was not an anticipatory assignment of income from property, but was a completed transfer of a present interest in property. The Court held that the donative assignment of income cases were inapplicable. The acquiesence of this decision was published in C B XII-1, p. 9, and this acquiesence remained extant until withdrawn in 1949, when it was ruled that the donation of short-lived oil payments carved out of larger interests was the assignment of future income. This 1949 ruling was made prospectively only (I T 3935, 1949-1, C. B.

1939). Likewise, in *Ortiz Oil Company v. Commissioner*, 37 B T A 656 (1938), affirmed 102 F 2d 508, C C A 5, 1939, certiorari denied 308 U S 566, and again in *Majestic Oil Corporation v. Commissioner*, 42 B T A 659 (1940), the Government affirmatively argued that the sale of a carved out oil payment was not the sale of income from the property, but was the sale of an economic interest of oil in place, resulting in taxable gain to the seller. It was also the position of the Government that the cash received was *not* ordinary income and the seller was *not* entitled to depletion with respect to such payment. This policy urged upon the Courts by the Government was accepted by the Courts. Again this policy was publicized by the published acquiesence in the Majestic case, C. B. 1940-2, p. 5.

Not one of the oil payments involved in these proceedings was "short lived" within the meaning given that term in G. C. M. 24,849. All had lives of more than three years, and the four Fleming payments had lives varying from five years and eight months to twelve years. (Petitioners brief, pp. 6, 11 and 12).

All transactions, except the Lake, occurred before 1950, when I. T. 4003, C. B. 1950-1, p. 10, announcing the Commissioner's present theory was promulgated.

The Commissioner has no special regulatory power as to the capital gain sections of the 1939 code. His

regulatory power here is limited to enforcement. Sec. 62 I R C of 1939.

Congress approved the long-term capital gain treatment of carved-out oil payments by reenacting, without pertinent changes, the capital gain sections of earlier Acts in the Internal Revenue Code of 1939, and by leaving these provisions unchanged in the many subsequent amendatory Acts, and in the Internal Revenue Code of 1954.

The 1950 ruling of the Commissioner (I T 4003, C. B. 1950-1, p. 10) upheld by this Court in reversing these cases, is retroactive legislation, contrary to *United States v. Leslie Salt Company*, 350 U.S. 383. Under the same authority, the Commissioner was powerless to change, as to transactions occurring after I. T. 4003 was issued, his previous interpretation which had been approved by Congress.

Neither the petitioners nor this Court denies, nor can deny, that the transactions under consideration come within the literal language of the capital gain section. To permit the Commissioner to say that, today, a certain transaction is the sale of a capital asset and, tomorrow, it is not, is not the exercise of an administrator's rule-making power, but the improper exercise of legislative power. The so-called ascertainment of the intention of Congress, made 25 or more years after Congress acted, with the conclusion directly contrary to that previously reached by the Commissioner many years nearer the action is wholly unconvincing; all the more so, when the only Congressional expression, other than the plain words of the statute, evidenced a desire to encourage sale of "mineral" and other properties.

II. Tax Rates and The Classification of Subjects of Taxation Are For Congress

On the question of whether a particular sales transaction bears a 25% rate or a 91% rate, the answer should be found in the plain language of the Statute and not on some nebulous theory, such as the doctrine of the Horst case (*Helvering v. Horst*, 311 U.S. 112), drawn by this Court from an alien area of the tax laws. The Horst case, itself, on the donative assignment of income area has its limitation, as evidenced by the decision of this Court in *Blair v. Commissioner*, 300 U.S. 5. The difficulty in drawing the line between cases like Horst and that like Blair was recognized by the Court itself in *Harrison v. Schaffner*, 312 U. S. 579, 583, where the Court said:

> "* * * we leave it to future judicial decisions to determine precisely where the line shall be drawn between gifts of income-producing property and gifts of income from property of which the donor remains the owner, for all substantial and practical purposes."

Since income tax law—nor less than criminal law—should be clear and certain, it is respectfully submitted that it was error for this Court to extend this uncertain and nebulous principle into the capital gain area.

And even if the nebulous and uncertain Horst principle is to be written into Section 117, it is clear that the Court went too far in holding that all carved out

oil payments, irrespective of life—including the 12-year oil payment in the Fleming case—are to be treated simply as anticipations of future income under the Horst doctrine. If the Horst doctrine is to be written into Section 117, it seems obvious that, while there may be some significance attaching to the retention of an interest in the property, if the oil payment sold is insubstantial in relation to the reversionary interest kept, the retention of an interest has no relevancy whatever if the opposite is true and the oil payment interest be substantial and the reversionary interest remote or unsubstantial. If a taxpayer owning an oil property with a twenty year life should sell a two or three year oil payment and keep the residue of his property, then it might be contended as a practical matter, under an extension of the Horst doctrine, that the seller is simply enjoying or anticipating fruits flowing from a continued ownership of the property. But if, as in the Fleming case, he sells a twelve year oil payment, and his reversionary interest is remote or insubstantial in relation to what he sold, it cannot be said that he has simply anticipated income and has retained the corpus that produces such income. It cannot be said that the really small amount retained is the corpus and the very large interest sold is the income. It cannot be said, as in the Horst case, that he is simply enjoying the benefits of continued ownership of property. Thus, if the Horst principle is to be applied to carved out oil payments, the rule quoted above in *Harrison v. Schaffner* must be applied. This rule has been recognized frequently by the Courts. See *McAllister v.*

Commissioner, 157 F 2d 235; *Haven v. Commissioner*, 231 F 2d 349 (C A 5); *Lum v. Commissioner*, 147 F 2d 356 (C A 3).

If the Horst doctrine is to be applied in this area, then it is incumbent upon the Court to remand these cases and afford the parties and the trial court an opportunity to develop the facts necessary to an application of the broad principle which this Court should clearly enunciate. These principles should be so delineated as to enable the trier of the fact to draw the line, as this Court stated in the *Schaffner* case supra, between "gifts of income producing property and gifts of income from property of which the donor remains the owner for all substantial and practical purposes."

III. As to Depletion

The grantee in an oil payment conveyance acquires a depletable economic interest in the property from which the interest came because such grantee can look

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Petitioners' reply brief (which was not made available to respondents' attorneys until the day this case was argued) attempts to deal with this "double depletion" question. See Point 4, pp. 9-11. The statement there made that the oil payment grantee does not acquire a depletable economic interest but recovers his investment by amortization, in addition to being a mere play on words, is contrary to the continuous Treasury practice (which is, and always has been, to allow any oil payment holder a deduction for depletion) and to the decisions of all of the Courts, except perhaps, that of the 7th Circuit in *Commissioner v. Slagter*, 238 F 2d 901. It is also contrary to the position taken in petitioner's original brief in footnote 17, page 38, and is di-

only to oil (or gas) when, as and if produced for the return of his investment. Under all of the holdings of this Court from *Palmer v. Bender*, 287 U S 551 (1933) through *Commissioner v. Southwest Exploration Company*, 350 U S 308 (1957) this is all that is necessary to permit and require the grantee to look only to the depletion allowance for the recovery of his investment.

The controlling statutory provisions, *Sections 23 (m) and 114(b)(3)*, Internal Revenue Code of 1939 (Appendix A, pp. 72, 73, 74 Lake and Fleming brief) provide as to any oil or gas property for a single depletion allowance to be apportioned among all of those who have economic rights in the property. See also *Helvering v. Twin Bell Oil Syndicate*, 293 U.S. 312.

This Court has held that any method which permits two parties to have a depletion allowance with respect to the same amount of oil production is erroneous. *Helvering v. Twin Bell Oil Syndicate*, 293 U.S. 312.

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rectly contrary to the basic rule of *Palmer v. Bender*, 287 US 551-557 that "the language of the statute (regarding depletion) is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship income derived from the extraction of oil, to which he must look for a return of his capital." Any contrary holding reverses a dozen or more decisions of this Court and the continuous practice of the Treasury—both of which have been repeatedly approved by Congress through repeated reenactment.

Since depletion cannot be denied the grantee of an oil payment interest with respect to the oil applicable to such oil payment, the holding of this Court that the grantor of such an oil payment interest is entitled to depletion measured by the consideration received necessarily result in the prohibted double depletion allowance.*

D. *The Court Erred in Holding Section 112(b)(1) Internal Revenue Code of 1939 Inapplicable to the Fleming Exchanges.*

The Flemings and Walsh clearly had capital investments in their several holdings. These investments were not "liquidated" when they received lands in exchange for a portion of these capital investments. The pertinent definition of "liquidate" is "to convert into cash." Certainly this was not done. The investment continued without liquidation. Since these respondents parted with "interests in land" in exchange for lands, the requirement of the statute and regulations for non-recognition of gain have been met. The Commissioner's interpretations (See I. T. 4093, C. B. 1952-2, p. 30, holding Section 112(b)(1)

* There is no difference, important here, between the carved-out net profit interest dealt with in the *Southwest Exploration* case, 350 US 308, and the carved-out oil payments involved here. The holding of this Court that the grantee of the carved-out net profit interest in the Southwest case was entitled to the depletion allowance on the income applicable to such interest and that the grantor was not, illustrates both phases of the depletion rule which this Court violated in its opinion in this instant case.

applicable to the exchange of an oil lease for lands —

The only thing of value attaching to the oil lease involved in this ruling was the right to oil and gas when produced. This is as much "future income" as is the oil and gas applicable to an oil payment.

Fleming and Lake brief, p. 127, and likewise applicable to the exchange of water rights for land, Rev. Ruling 55-749, 1955 C. B.-2, p. 295, Fleming-Lake brief p. 131) reenforce this.

Conclusion

The transactions here under consideration are not "devices" either "artful" or "transparent" as the Court characterized them. Each was a bona fide business transaction entered into in reliance on long-continued Treasury practice, expressly approved by the Courts and, through re-enactment of the applicable statutory provisions, by Congress. Nor would the affirmance of the holdings below open the door of the Treasury vaults to oil operators. Any operator who makes a practice of selling carved-out oil payments is, by the express terms of *Section 117, I R C of 1939*, a dealer, just as is a real estate subdivider, and is taxable on gains therefrom as ordinary income, *without any allowance for depletion*. As the petition for certiorari shows, the petitioners were able to locate only some 43 cases involving the question. This necessarily covers the 1946-1957 period, where hundreds of thousands of oil operators reported as to multiplied hundreds of thousands of oil properties. Against this factual background, the number of pending cases

and the amounts of taxes involved, *as asserted* by the petitioners, are trival.

If, as it should not be, the effect of the holding on tax revenues is an appropriate consideration, it should be remembered that every tax rule cuts both ways; and that, since G. C. M. 24,849 was promulgated, it has frequently been availed of to decrease taxes by avoiding the application of the limitation on the percentage depletion allowance and thereby increasing tax-free allowable percentage depletion.* It is con-

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* The allowance for percentage depletion as to an oil and gas property is 27-1/2% of gross income but not more than 50% of net income calculated before depletion. Section 114 (b)(3) I R C of 1939 (Lake-Fleming brief pp. 78-79). The method of increasing percentage depletion available under G C M 24,849 and this Court's opinion is easiest illustrated by a hypothetical situation in which a property is developed in one year and intangible drilling costs are expensed, as expressly premitted by statute. Two years, with and without the use of a carved-out oil payment producing depletable income will be used.

	Without Oil Payment		With sale in 1st year of 1 year oil payment yielding $200,000	
	1st Year	2nd Year	1st Year	2nd Year
Gross Income	250,000	500,000	450,000	300,000
Dev. Expense	150,000	None	150,000	None
Operating Exp.	75,000	125,000	75,000	125,000
Net Income before Depletion	25,000	375,000	225,000	175,000
Depletion	12,500	137,500	112,500	82,500
Taxable Income	12,500	237,500	112,500	82,500

fidentally asserted that, tax-revenue wise, this is much more important than would be the allowance of capital gain with respect to carved-out oil payment sales.

These cases should not be decided upon the basis of the effect of the decision on revenues, nor by attributing to Congress—more than three decades after its original action in 1921—an intention contrary to the plain meaning of the language used, and the intention expressed in the reports of its Committees.

Wherefore, respondents respectfully pray that this petition be granted.

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The assumed production in the second year is larger than the first because all wells would be operated for the full year. Increase in depletion allowances by "artful" use of this Court's holding, $45,000—with corresponding decrease in taxable income.

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Harry C. Weeks, attorney of record for respondents, P. G. Lake, Inc. and Wm. Fleming et al., hereby certifies that the foregoing petition for rehearing is presented in good faith and not for delay.

Harry C. Weeks